

Financial Sector Review and Strategy

**Final Report:
Conference Proceedings**

TASK 6 REPORT



Submitted by:
Deloitte Touche Tohmatsu Emerging Markets, Ltd.

Submitted to:
EGAT/EM

Contract No.:
PCE-I-00-99-00008-00, Task Order: 1

February 28, 2003

AGENDA

Financial Sector Annual Review and Strategy: Forum

Wyndham City Center Hotel
Lower Level Ballroom
1143 New Hampshire Avenue
Washington, D.C.
December 11-12, 2002

AGENDA

DAY ONE: ANNUAL REVIEW OF FINANCIAL SECTOR ACTIVITIES

1:00 – 1:15 PM

WELCOME AND OBJECTIVES

John Crihfield, SEGIR-Financial Services Component Manager

IMPLEMENTER PANELS: LESSONS LEARNED

1:15 – 2:00

Banking Systems: When Systems Fail

Moderator: Chris Barltrop, Private Enterprise Office, EGAT Bureau

Presenters: David Cook, Executive Director, Bearing Point (*Bank failures and asset management*)

Laura McQuade, Managing Director, FSVC (*Financial crimes*)

2:00 – 2:45

Financial Sector Supervision and Regulation: Getting Systems to Work

Moderator: Jean Lange, Economic Growth Office, Europe & Eurasia Bureau

Presenters: James Horner, Lori Bittner, Managing Directors, BearingPoint (*Bank supervision*)

Anthony Sinclair, Director, Deloitte Touche Tohmatsu (DTT) (*NBFI supervision*)

2:45 – 3:30

Capital Markets: Building Financial Sector Infrastructure

Moderator: Brad Wallach, Chief, Private Enterprise Office, EGAT Bureau

Presenters: Constantin Abarbieritei, Senior Manager, IBM (formerly PWC)

Charles Seeger, Chairman and CEO, Financial Markets International, Inc. (FMI)

3:30 – 3:45

BREAK

3:45 – 4:30

Pension and MSME Finance: Subsectors of the Financial Markets

Moderator: Denise Lamaute, Senior Pensions Advisor, Office of Poverty Reduction, EGAT Bureau

Presenters: Joe Dougherty, Senior Manager, DTT (*Pensions*)

Charu Adesnik, Manager, DTT (*Pensions*)

Anita Campion, Sr. Manager, Banking and Enterprise Development, Chemonics International (*Micro, small, and medium enterprise finance*)

4:30 – 5:15	Accounting, Disclosure, Corporate Governance: Financial Sector Accountability Moderator: Hugh Haworth, Economic Growth Office, Europe & Eurasia Bureau Presenters: Geoffrey Elkind, Manager, BearingPoint Philip Smith, Development Alternatives Inc. (DAI)
5:15 – 5:30	Wrap-Up John Carihfield

DAY TWO: USAID/EGAT/OEG FINANCIAL SECTOR STRATEGY

8:30 – 9:00 AM	COFFEE/REGISTRATION
9:00 – 9:15	WELCOME AND RECAP Steve Hadley, Director, Office of Economic Growth John Carihfield
9:15 – 9:45	DONOR STRATEGY IN THE FINANCIAL SECTOR Millard Long, Centennial Group, FS Review Team
9:45 – 10:30	REVIEW OF USAID's FS ACTIVITIES Alan Batchelder, EWMI, FS Review Team
10:30 – 10:45	BREAK
10:45 – 11:15	OTHER DONORS' FS TECHNICAL ASSISTANCE ACTIVITIES Gillian Garcia, GGH Garcia Associates, FS Review Team
11:15 – 12:00	IFI and OTHER DONOR OR AGENCY PERSPECTIVES Moderator: Gillian Garcia Panelists: Larry Promisel, co-Chief, FSAP, The World Bank Joe Englehard, Deputy Assistant Secretary, US Treasury Robert Strahota, Assistant Director, International Affairs, US SEC
12:00 – 12:30	Introduction of Keynote Speaker: Jock Conly, DAA, EGAT Bureau Keynote Speaker: Gerard (Jerry) Caprio, Director, Operations and Policy Department, Financial Sector Operations Vice Presidency, The World Bank
12:30 – 1:30	LUNCHEON
1:30 – 2:00	OPTIONS FOR EGAT/OEG Teresa Mastrangelo, Deloitte Touche Tohmatsu
2:00 – 3:15	IMPLEMENTERS' COMMENTS Moderator: Alan Batchelder

3:15-3:30	BREAK
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3:30 – 4:30

MISSION AND BUREAU COMMENTS**Moderator:** Alan Batchelder**Panelists:** Rebecca Maestri, ANE Bureau
Chuck Mohan, LAC Bureau
Skip Kissinger, EGAT
Ashok Jha, USAID/India
John Wasielewski, DCA
Bryan Kurtz, GDA

4:30 – 5:15

GENERAL DISCUSSION**Moderator:** Alan Batchelder

5:15

WRAP-UP AND ADJOURN**John Crihfield**

PROCEEDINGS

**Financial Sector Annual Review and Strategy: Forum
Workshop Proceedings
December 11, 2002**

Day I – ANNUAL REVIEW OF FINANCIAL SECTOR ACTIVITIES

Welcome and Objectives

Steve Hadley, Director, Office of Economic Growth, EGAT/EM, USAID, welcomed participants to the Forum, acknowledging the contributions of USAID colleagues from Washington and from the field, USAID implementers including SEGIR contractors and FSVC, and special guests from other US Government agencies, the World Bank, and the donor community.

USAID future technical assistance activities must be set in the context of global trends in financial sector development, and build on USAID's competencies and comparative advantages vis-à-vis peers in the donor community. There is little disagreement among the donor community that financial sector reforms are central to achieving reductions in poverty and sustainable economic growth. At the same time, one must not lose sight of the fundamental link between economic development and strong financial markets. Sound financial systems are fundamental to economic growth and poverty reduction, because they channel scarce capital resources to their most productive uses. Financial policymaking is one of the central development issues of our time.

John Carihfield, SEGIR Financial Services Component Manager, EGAT/EM, USAID, also welcomed the participants and provided further details on the agenda for the conference. He made a brief announcement regarding logistics and then introduced Chris Barltrop, moderator of the first panel.

Implementer Panels: Lessons Learned

On the first day, several panelists were asked to address central financial sector issues; present time-tested and proven methods and approaches (lessons learned); and provide an overview of what these lessons mean for USAID financial-sector programs, more generally.

Session 1 – Banking Systems: When Systems Fail

Chris Barltrop, Enterprise Development Financial Sector, EGAT/EM, USAID introduced the first panel entitled "Banking Systems: When Systems Fail". He then introduced David Cooke, Executive Director, BearingPoint, Inc. as the first speaker. Laura McQuade, Managing Director, FSVC was scheduled to present on Financial Crimes, however she was unable to attend the forum.

I. Bank Failures and Asset Management

David Cooke, Executive Director, BearingPoint, Inc. gave a presentation on their experiences in addressing bank failures and asset management projects, stressing the importance of stable banking systems for achieving sustainable economic development. They emphasized the point that unhealthy financial institutions impeded efforts to achieve sustainable growth and prevented other financial sector reforms from fully achieving intended results. The team then discussed their proposed solutions and lessons learned.

Proposed Solutions

In discussing potential solutions for addressing bank failures and asset management, the team highlighted the following issues.

- Cure – Before starting a project, teams should perform an assessment/diagnostic to determine the issues, design a strategy (rehabilitation, liquidation, or sale) that is consistent with government objectives, and then design an implementation program. For Asset Management and Recovery projects, teams should identify the issues involved, prioritize them, and conduct a market assessment to determine potential strategies then develop an implementation plan.
- Climate – The team emphasized the importance of a deposit insurance program. In order for the financial sector to be successful, bank depositors, creditors and investors need to have confidence in the market. Creditors should be aware of their rights and the market should be focused on competition and discipline. In establishing a deposit insurance program, teams should focus on: strategic design, coverage and funding, governance and management, organization and operations and focused development of the functional areas involved.
- Support functions such as public education, MIS/IT, accounting and reporting, and oversight are also important in the development of a strong financial sector.

Lessons Learned

The major lessons learned and highlighted during the presentation included:

- Allow time to build institutional capacity for credible non-repayment resolution
- Provide sufficient hands-on training to allow for testing of the resolution strategies and procedures
- Engage the private sector, as they often know what the barriers to success are
- Get involved early, otherwise assistance ends up as ‘damage control’

Session 2 – Financial Sector Supervision and Regulation: Getting Systems to Work

Jean Lange, Economic Growth Office, Europe & Eurasia Bureau, USAID opened the second session by providing an overview of USAID's work in Financial Sector Supervision and Regulation. Strong effective bank regulatory institutions and the effective enforcement of prudential rules and standards are critical to the development of healthy vibrant banking systems. It is the only way to build confidence in badly damaged banking system and prevent crises from happening or if they happen to manage them well and reduce their impact on the real economy.

Economic reform is about building capacity and changing the way institutions and people behave. If USAID wants to accelerate this process, it is important to understand that banking sector reform, is not just a question of drafting and enacting good laws, or translating US bank supervision manuals, or training supervisors in CAMELS. These are easy to do. It means changing the institutional and organizational environment in which regulators operate. It means building up the credibility and legitimacy of institutions and their staff. USAID can't just provide tools, the experts have to give the institutions and their staff the ability to understand these tools and to use them with knowledge and confidence. It is crucial to get people to act differently and use judgment in a world where in the past judgment only caused one to be in trouble.

Lessons Learned

Before USAID-assisted reform projects there was a lack of understanding of bank supervision in the Eastern European transition countries, -- it was called control. There were excessive regulations not related to the types of risk incurred in the marketplace. Initial reactions of post-communist countries was that excessive regulation was what they were trying to minimize,- intrusion into the private sector. USAID has had to build up credibility among its clients and this was bound to take time; however a few things help along the way:

- The most important thing that USAID does in most of its technical assistance, not just in banking, is programs design. Programs provide the ability to provide a package of solutions, encompassing a wide array of activities.
- The other important point is reliance on resident advisors, supplemented by intermittent experts. These things do set USAID apart from other donors and are critical in the world of banking system reform.
- The specific skills of the advisors are critical. It is not enough to hire someone who has worked at the OCC, or the FDIC, OTS or Fed. The details matter.
- It must be understood that USAID will never get the assessment of the problem right in the initial task order. The project designers and managers are going to be premature in some cases and not ambitious enough in other areas. Flexibility about the technicalities of the assignment, the time frames, the details in the implementation of the workplan is important.

Successful programs in bank supervision must always help the regulators improve their relationship and reputation with the banking community through better communication and common work and training.

Finally, Ms. Lange introduced the speakers, James Horner and Lori Bittner, Managing Directors, BearingPoint, and Tony Sinclair, Director, Financial Sector Development, Deloitte Touche Tohmatsu Emerging Markets, to comment on the differences between bank and non-bank financial sector development. In the banking sector institutions that already exist but don't work properly have to be reformed while in the case of securities markets and pension, have to build institutions primarily from scratch.

I. Bank Supervision

James Horner and Lori Bittner, Managing Directors, BearingPoint, Inc., discussed the importance of supervision for an effective banking sector. An overview of the components of supervision was presented, highlighting the need for regulations, interpretations, policy guidelines and advisory bulletins. Stress was placed on the importance of sustainable capacity building through the institutionalization of a banking supervisory culture. The team then discussed some of the challenges faced in implementing banking supervision programs, such as inadequate legal framework, lack of a compliance culture, inadequate processes and organizational structure, and antiquated information systems. In order to demonstrate lasting positive effects through technical assistance, it is important to address all of these issues. Suggestions for further programs included focusing on the long-term effort and utilizing experiences gained through the implementation of bank supervision programs to jumpstart supervision of non-bank financial institutions.

Lessons Learned

The major lessons learned and highlighted during the presentation included:

- Use international 'best practices' as a guide not as a model to success.
- MUST obtain counterpart trust and 'buy-in'
- Strengthening the financial sector is a long-term endeavor
- Bank supervision impacts political, social and economic platforms
- Successful programs help strengthen both the supervisory agency and the financial sector simultaneously

II. Non-Bank Financial Institutions (NBFI) Regulation and Supervision

Tony Sinclair, Director, Financial Sector Development, Deloitte Touche Tohmatsu Emerging Markets, Ltd. Began the discussion with an overview of the role and importance of NBFIs --- insurance companies, mutual and pension funds, securities markets, credit coops, leasing and financial companies --- in financial markets. NBFIs act as vehicles for savings mobilization, add depth and liquidity to financial markets, provide alternative sources of finance, facilitate resource allocation, and permit the transfer of risk. The importance of NBFIs in the

financial sector is evidenced by the fact that, as economies grow and mature, so too does the role of NBFIs, often with a higher role/level of importance than the banking sector. A regulatory trend over the last several years is to integrate regulation. Broadly, the goals of integrated regulation are to achieve neutrality in regulation among financial institutions, scale the intensity of supervision by the degree of market failure each institution represents, improve the coordination of regulation towards different objectives, and sharpen oversight of financial conglomerates. Integrated regulation can also facilitate achievement of economies of scale, by organizing functions to minimize overlap, duplication and conflicts in regulation.

Lessons Learned

To establish an integrated framework for regulation of NBFIs, it is important to keep in mind that not all financial institutions need to be regulated in the same fashion. The regulator must take into consideration the goals for each NBFI and the necessary oversight required before establishing regulations. The first step is to determine regulatory objectives (i.e., safety/soundness, market conduct, consumer protection, competitiveness, etc.). These objectives should drive the activities and accountability of the regulator. Once objectives are set, various tools can be designed around prudential standards, market conduct, entry requirements, disclosure, etc. Next, regulation is applied, the intensity which should be calibrated depending on the particular industry and level of risk it represents. For example, the intensity of regulation of banks may be much higher than for leasing companies, given that bank failure can have a significant impact on the financial sector. Similarly, the type of supervisory response should be geared to the severity and frequency of misconduct. Intervention options, therefore, should be proportional, and can range from a notice of censure to revocation of license to criminal prosecution, depending on the type of misconduct.

Potential areas for USAID assistance include defining overall regulatory philosophy and key objectives, developing regulatory frameworks for each industry, drafting specific regulations, developing supervisory approach for each industry along with associated guidelines, and designing and delivering training to regulatory and industry professionals.

Session 3 – Capital Markets: Building Financial Sector Infrastructure
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Brad Wallach, Chief, Enterprise Development and Financial Sector, EGAT/EM, USAID introduced the “Capital Markets: Building Financial Sector Infrastructure” panel, which consisted of two speakers, Constantin Abarbieritei, IBM and Charles Seeger, Financial Markets International, Inc.

I. Capital Markets I

Constantin Abarbieritei, Senior Manager, IBM Business Consulting Services, Inc. provided an overview of some of the challenges faced in implementing capital markets projects in transitioning economies. He then discussed global trends in capital markets and how they affect developing markets. In his concluding remarks, Mr. Abarbieritei presented lessons learned and possible interventions going forward.

The major challenges highlighted in the presentation were the low volumes of financial transactions in the markets, high transaction costs, lack of regulatory transparency and enforcement, and uncertain sustainability. USAID has attempted to address these issues by providing assistance for legal reform, development of regulatory capacity, establishment of trading platforms, and the formation of self-regulatory organizations. The results of each of these programs has been mixed.

Some of the major global trends affecting the developing capital markets include the liberalization of cross border investment flows, consolidation of financial services firms, expansion of financial instruments, harmonization of disclosure requirements, and active corporate governance pressures to implement higher standards. Going forward, financial markets reform should focus on building regulatory frameworks, helping to develop industry skills, and implementing international standards and best practices. For capital markets development, it is important to have coordination among donors in the implementation of policies initiatives and direct financing of capital for private sector development.

Lessons Learned

The major lessons learned and highlighted during the presentation included:

- Legal reform is imperative and should be coordinated with the other donors to help focus the government
- In building regulatory capacity, it is important to leverage local champions
- Progress for the development of self regulatory organizations in “early stages” market is slow and therefore, donor patience is required

II. Capital Markets II

Charles Seeger, Chairman and CEO, Financial Markets International, Inc. centered his discussion on the basic tenants for successful development of capital markets. His main view was that, although there are some unique factors in each environment, there is only one money culture. Successful capital markets honor the money culture and should follow certain basics principles, such as accurate disclosure, reliable delivery vs. payment systems, and effective corporate governance. Countries who continue to lag in their economic development because they choose to argue for their “uniqueness”, make this choice because they deliberately choose not to embrace such reform. Mr. Seeger’s suggestion to donors for countries who choose not to reform is to stop providing aid and let them fail. Although the money culture should be the same for each country, Mr. Seeger argues that the delivery of assistance for reform to the money culture may need to be tailored slightly to contextualize the information. while the fundamentals should remain the same.

Lessons Learned

The major lessons learned and highlighted during the presentation included:

- Prepare: Pursue the best no matter the difficulty, only performance speaks
- Certain fundamentals must be in place, followed, and enforced if capital markets functions are to succeed
- Reform takes time and dedication
- Crucial to gain complete “buy-in” with the local citizens for successful implementation

Session 4 – Pensions and MSME Finance: Sub sectors of Financial Markets

Denise Lamaute, Senior Pensions Advisor, Office of Poverty Reduction, EGAT Bureau, USAID introduced the “Pensions and MSME Finance: Sub sectors of Financial Markets” panel. The speakers on Pensions were Joe Dougherty, Senior Manager and Charu Adesnik, Manager, Financial Sector Development, Deloitte Touche Tohmatsu Emerging Markets, Ltd. Anita Campion, Senior Manager, Banking and Enterprise Development, Chemonics International presented on micro, small and medium enterprise finance.

I. Pension Reform: Opportunities and Challenges for USAID

Joe Dougherty, Senior Manager, and Charu Adesnik, Manager, Financial Sector Development, Deloitte Touche Tohmatsu Emerging Markets, Ltd. began the presentation with a review of the central objective of mandatory pension systems: the avoidance of future social costs associated with a large number of elderly poor. To achieve this objective, a national pension system should ensure adequate retirement income to system participants, achieve full coverage of the appropriate target group, maintain long-term financial sustainability, and support (or at least not hinder) general economic growth. Demographic drivers, such as an aging population combined with lower birth rates, along with other factors such as poorly designed, regulated or managed pension program can cause severe problems, including crowding out private savings and investment, straining government budgets, causing civil unrest or redistributing wealth from the poor to the rich. On the other hand, an effectively designed pension system can, in fact, facilitate significant GDP growth as was demonstrated in the sample projections from Thailand.

The general trend in pension reform is pulling away from the Pillar I system towards a multi-pillar system, contributions instead of defined benefits and allows for individual choice in investment decisions. A multi-pillar system also allows for more private management of assets (instead of government control), and provides new ways to blend pillars and provide minimum guarantees. However, it should be stressed that the balance among pillars should reflect the economic and political realities of the specific country – there is no “one size fits all” approach.

Lessons Learned

Many client countries are in need of assistance in pension reform, which USAID can provide through grant assistance. Each solution must be tailored to specific country needs and impacts, requires careful consideration and appropriate interventions, as well as proactive public outreach and education to ensure political support.

Potential intervention options for USAID were discussed. At the outset, evaluations can be conducted to assess current pension systems and determine the needs for intervention. These initial assessments are low cost, can be completed quickly and can provide some ‘insurance’ that subsequent interventions will be targeted, appropriately sequenced, efficient and, ultimately, more successful. Potential areas for more dedicated assistance include policy design, reform of existing systems, governance, investment management and MIS/IT systems.

II. Micro, Small, and Medium Enterprise Lending

Anita Champion, Senior Manager, Banking and Enterprise Development, Chemonics International, discussed the importance of Micro, Small and Medium Enterprise (MSME) Lending for economic growth. In the past, USAID IQC’s have been highly focused on banking and microfinance. However, SMEs represent a large underserved market and offer the most employment and growth potential. Lessons from both banking and microfinance can be applied to the MSME sector. Two approaches to MSME finance that were highlighted were: (1) downscaling, working with commercial banks to offer smaller loans through a guarantee facility, and (2) upscaling, working with a microfinance institution to offer larger loans. The Uganda SPEED project was highlighted as a successful program in this area.

Lessons Learned

The major lessons learned and highlighted during the presentation were:

- Include an enabling environment component to promote and advocate a positive regulatory environment
- Reduce risks - assess character, analyze cash flow of business and households, use collateral and co-signature guarantees
- Know your market
- Develop MSMEs holistically, link to business development services, competitiveness and sub sector strategies
- Initially, focus on the domestic markets – it is hard for small enterprises to leap to export markets

Session 5 – Accounting, Disclosure, Corporate Governance: Financial Sector Accountability

Hugh Haworth, Economic Growth Office, Europe & Eurasia Bureau, USAID introduced Session 5 “Accounting, Disclosure, Corporate Governance: Financial Sector Accountability.” Philip Smith and Jay Dyer, Development Alternatives, Inc., presented first followed by Geoffrey Elkind, BearingPoint, Inc.

I. Accounting Reform and Corporate Governance

Philip Smith, Chief of Party for Accounting Reform in Russia, Development Alternatives International focused his discussion on the case of Accounting Reform in Russia, which consisted of two tasks: (1) providing support to the reporting committee, the technical accounting and training committee of the IACC, and (2) organizing and conducting accounting pilot projects in selected commercial banks. He presented the project strategy, outputs and tangible results.

Lessons Learned

Based on the experience in Russia and five other countries, Mr. Smith highlighted the lessons learned as:

- Immediately, push for laws on current and future IAS compliant accounting
- Achieve full ‘buy-in’ from counterparts, by sharing TOR, work plans, etc
- Consider funding salaries of IAS specialists for the Central Bank
- Consider TA to universities to add IAS to the curriculum
- Conduct training in corporate governance for senior managers, line managers and internal auditors within the central banks
- Include international and local accounting firms and tax inspection personnel in the training process

Jay Dyer, Senior Development Specialist, Development Alternatives Inc., centered his discussion on corporate governance issues. He presented two case studies, The Agricultural Bank in Mongolia and the National Microfinance Bank in Tanzania, and discussed the results of each. The core objectives were to turn around the banks to restore financial soundness, provide financial services to underserved “missing” markets and to prepare the banks to operate independently. The teams focused on increasing accountability in bank management through modifying the corporate culture, preventing political influence, changing the composition of the board of directors and senior management, increasing transparency and analyzing and revising current policies and procedures.

II. Accounting, Disclosure and Corporate Governance

Geffrey Elkind, Manager, BearingPoint, Inc., provided an overview of some of the financial sector challenges faced in most emerging markets, which included: no accountability in the legal framework, no corporate governance culture, resistance of local custom and practice to reform, and poor or non-existent enforcement. He then emphasized the importance of a longer term development horizon; standardized diagnostic approaches; targeted frameworks to manage gaps, inefficiencies, and conflicts; and targeted capacity building and training. Suggestions for future programs included building on the World Bank ROSC diagnostic approach, development of best practice codes, legal/regulatory/judicial reforms, training and certification programs.

Lessons Learned

The major lessons learned and highlighted during the presentation included:

- Use “bright-line” concepts, approaches and strategies
- Good governance starts at the top
- Anti-corruption efforts are not optimal
- Perceptions matter – enforcement is key
- Effectively empower and educate stakeholders
- Sustainable reform – buy-in and capacity building

Overview of US Patriot Act

William Langford, Senior Counsel for Financial Crimes, Office of the Assistance General Counsel, US Treasury, The US Patriot Act and especially its potential influence on USAID and its programs was debated in the end of the first day. Langford focused his discussion on several of the issues that the US Treasury Department is facing in communicating the logistics involved in the implementation of the Act to banks, both in the US and abroad. He was interested in discussing ways that USAID and the implementers could also pass along the information regarding the Patriot Act to international banks. If there are any questions or if anyone needed more information, Mr. Langford encouraged people to contact him at william.langford@do.treas.gov.

As the seminar had gone slightly over time, **John Carihfield, SEGIR Financial Services Component Manager, USAID** made a few closing comments, thanking the moderators, speakers, and participants. He then concluded the first day of the seminar.

**Financial Sector Annual Review and Strategy: Forum
Workshop Proceedings
December 12, 2002**

DAY 2 – USAID/EGAT/EG FINANCIAL SECTOR STRATEGY

On day two of the conference, the team from Deloitte Touche Tohmatsu discussed the preliminary results of the work on the Financial Sector Review and Strategy. Comments on these findings from USAID colleagues, major implementers, and partner donors and agencies in the development community followed.

Welcome and Recap

Steve Hadley, Director, Office of Economic Growth, EGAT Bureau, USAID, opened the second day of the seminar by welcoming all participants and providing an overview of the agenda for the day. He then commented on the new challenges in financial sector development that will affect USAID's programs, which included redirection of human and financial resources, new mechanisms for funding development assistance, the decrease in funding for Central and Eastern European countries and the reorganization that resulted in the formation of the Economic Growth, Agriculture and Trade (EGAT) Bureau.

The focus for the second day of the conference were the preliminary results of the work of the team from Deloitte Touche Tohmatsu on the Financial Sector Review and Strategy. Then, the comments of USAID colleagues, major implementers, and partner donors and agencies in the development community followed. The strategy discussed is a work-in-progress, and the views and comments of the participants were used to help make this work more responsive to financial sector developmental needs.

There are new challenges in financial sector development that will affect USAID's programs. First, the Agency's human and financial resources are being redirected to reflect the Bush Administration's priorities. Second, new mechanisms for funding development assistance, such as the Global Development Alliance, are starting to be incorporated into Mission interventions.¹ Third, funding for the Central and Eastern Europe region, which has received the bulk of USAID's financial sector funds in recent years, is being scaled back. Fourth, USAID has undergone a substantial reorganization that resulted in the formation of the Economic Growth, Agriculture and Trade (EGAT) Bureau.

EGAT management have a mandate to provide technical leadership and field support in all economic growth areas to USAID programs worldwide. This includes work in financial sector development. Accordingly, the Office of Economic Growth, EGAT Bureau engaged the Deloitte team to undertake a series of targeted studies on the evolution of global financial markets to assist in the development of strategic options for OEG's role and activities for the next ten years.

¹ The Deloitte team did not undertake a review of the Global Development Alliance.

John Carihfield, SEGIR Financial Services Component Manager, USAID, also welcomed the participants to the second day of the seminar, introduced the speakers and provided further details on the agenda for the conference.

The speakers for the second day of the conference included Alan Batchelder, Millard Long, Gillian Garcia, and Teresa Mastrangelo. Mr. Batchelder is a senior macroeconomist with over 40 years experience in the field of economics. He has been a professor of economics at the University level, a Ford Foundation visiting professor in Nigeria, a Senior Economist and consultant with Elliot Berg and a Senior Economist at the U.S. Agency for International Development where he was a Mission Chief Economist, and one of the leading senior economists focused on international policy reform issues and institutional economics.

Mr. Millard Long is widely regarded as one of the leading financial economists in the world specializing in policy analysis and advice. During his more than 25-year career in high-level policy formulation at the national and international levels, he has provided advice to senior policy makers on financial sector reforms and restructuring in some 30 countries, including China, Korea, Indonesia, Hungary, Russia and Turkey in the aftermath of the Asian Financial Crisis.

Ms. Garcia is a former Senior Economist with the International Monetary Fund, specializing in crisis management, financial sector assessments, financial modernization and financial sector regulation/supervision. Based upon her work with the Financial Stability Forum as well as her time at the IMF, she brings considerable knowledge of the reforms for international financial architecture with an emphasis on the banking industry. She was formerly with the Senate Committee on Banking, the Government Accounting Office and the US Federal Reserve. She has taught at several prominent US Universities on financial sector topics.

Teresa Mastrangelo is a well-known colleague of the SEGIR Financial Sector contractors present at the Forum and has been serving USAID for nearly 16 years. Ms. Mastrangelo is a Director in Deloitte Touche Tohmatsu Emerging Markets (Deloitte Emerging Markets), specializing in financial institutions. Until last year, she served as the SEGIR FS Project Manager for Deloitte. She has supported financial sector development in South America, Asia, Central Europe, and Russia and the CIS. In her role as team leader, she has been responsible for compiling the findings of her team members and presenting those to USAID.

After his presentation of the speakers, Mr. Carihfield passed the floor to the Millard Long, as the first speaker.

Donor Strategies in the Financial Sector

Millard Long, FS Review Team Member, Centennial Group, presented the Deloitte team's finding for the Task 1 report, which involved performing an evaluation of the international financial architecture. Mr. Long presented trends to introduce the financial sector topology and provide a common understanding of how it might assist USAID missions to program financial sector activities.

The Conference at Bretton Woods in 1944 established the post-war International Financial Architecture. Under the system, the prices of the major currencies were to be pegged, but adjustable if significant misalignments developed. The United States defined its currency in terms of gold and other countries defined theirs in terms of dollars. Trade was to be open, but there were to be controls on capital movements. The IMF was to monitor the rules of the system and would make loans to countries needing short-term liquidity to defend their exchange rates.

In the last 50 years, there have been many minor, and three major, adjustments to the system. In the late 1960s-early 1970s, the United States trade deficit grew too large to be financed. Too many dollar liabilities were generated. In the late 1960s, the SDR was created as an additional reserve currency, and in the early 1970s, the major currencies moved to floating rates with a concomitant fall in the value of the dollar. The second change came in the early 1980s with the Latin American debt crisis. Private creditors were forced to write down the value of their loans and the IMF and World Bank took on a new role, that of financing policy changes in developing countries to enable them to adjust following a major crisis. The third adjustment came in the late 1990s, this time in response to crises in some of the most important emerging markets. Instead of ex-post adjustment, the present changes in the International Financial Architecture are designed to reduce the incidence of crisis and to lessen its severity.

The recent adjustments have produced substantial improvements. With regard to domestic financial systems, reforms are underway. In the last decade the countries of Central Europe have been building financial systems which are increasingly operating on market principles. The systems are not perfect, but the remaining problems appear to be manageable. Several countries in Latin America and East Asia have made major reforms in the wake of crises. India and Turkey have recently taken steps to improve their systems. Many developing countries' financial markets are now more open to foreign participation. Exchange rate systems are moving from soft pegs toward systems that are more robust. Slowly but surely the quality of information in developing countries is also improving. Few developing countries have adopted the IAS in full but some are incorporating important aspects, in particular, the accounts of financial intermediaries are becoming more transparent with better treatment of non-performing loans and unpaid interest. These are substantial achievements; still all would agree that much remains to be done. And it is in these areas that USAID through its technical assistance programs has much to contribute.

In recent years, there have been reforms of the International Financial Institutions. There has been considerable improvement in surveillance, that is, gathering information and assessing country systems to see whether they meet codes and standards of best practice and remain free

from the dangers of crisis. But there is still controversy over the role and practices of the IMF as the lender of last resort. Does the IMF's approach reduce or increase the incidence and severity of crisis? Should only those countries that pre-qualify have access to crisis funding and are the IMF's ex post loan conditions the medicine for recovery, or invasive and unhelpful? Should crisis lending be bigger to stem contagion or smaller to prevent moral hazard; how high should the interest rate be on such loans and how long should be the term? We have pointed out that the IMF has made adjustments in both its approach and lending terms, but the changes made in this area seem marginal rather than radical.

In addition to the practices of the developing countries and the International Financial Institutions, the third objective has been to change the behavior of the providers of capital. Stabilizing capital flows is seen as an important action for reducing crises. Here too there has been substantial improvement, more in the mix of funding than in changing the behavior of capital providers. In value terms, foreign direct investment has become predominant and flows are quite stable. But bond and bank finance is still quite volatile. Can these aspects of finance be made more stable and can private lenders be made to bear more of the cost of crises? "Changes in the international financial system has been driven largely by the ever more rapid growth of private international capital flows, which first overwhelmed the Bretton Woods fixed exchange rate system, and, since the 1980s, has had especially strong effects on the emerging market countries. The evolving system poses several challenges, including the need to find ways of working constructively with the private sector in both crisis prevention and crisis response." (Fischer, 2000, 2). Because of the fear that actions taken to reduce volatility might also decrease the overall flow of capital, there has been reluctance to introducing mandatory regulations, such as collective action clauses in bond contracts. In most crises provisioners of all forms of capital have lost money. Still, to a degree, there has been some bailing out. The management of ex-post restructuring is still determined on a case-by-case basis, though the IMF has now proposed a new approach to sovereign debt restructuring, akin to domestic bankruptcy proceedings. However, private sector involvement is the area in which least has been accomplished to date.

Crisis seems to be an inherent flaw of capitalism. Painful though it is, countries experiencing the disease do recover. The disease has not one cause, but many. We should continue our efforts to find and ameliorate those causes but without the conceit that crisis will ever be eliminated.

Review of USAID's Financial Sector Activities

Alan Batchelder, FS Review Team Member, East West Management Institute, provided an overview of the report based upon Task 3 and 4 of the scope of work, which summarized their findings in the review of USAID's Financial Sector activities from 1988-2001. In the discussion, reference was made to the charts contained within the report, which showed greater details on the breakdown of spending between regions, countries, income levels and technical areas.

Between 1988 and 2001, USAID spent just over \$1.2 billion on financial sector development assistance through 761 individual interventions in some 87 client nations. The number of interventions initiated in a given year has fluctuated from a low of 14 (in 1988) to a high of 101 (in 1996), while the total expenditure on financial sector development assistance has also

fluctuated. On average, about 54 new projects were initiated each year with an average cost of about \$1.6 million per project. However, the cost per project has tended to increase over the past 14 years, from an average of \$337,000 in 1988-90 to an average of \$1.75 million per project in 1999-2001. It is not clear whether the changes in the level of new FSD authorizations each year reflect changes in the overall USAID budget or changes in the level of priority of FSD work relative to other areas. Nor is it clear whether the increase in average cost per project reflects a wider trend within USAID or is specific to financial sector assistance projects.

Well over half of the 14-year total of \$1.2 billion went to countries in Europe and Eurasia (E&E), while the rest was spent more-or-less evenly among other regions, as seen in the chart on the following page. This division should not be surprising given the high priority that post-Communist economies have received in the last decade. Within Europe and Eurasia, the funds were spread among 27 countries. It is interesting to note that, according to the World Bank's 1998 income criteria, 38% of the money was spent in low income countries, while 46% was spent in lower middle-income countries and 10% was spent in upper middle income countries.

The team analyzed the quantitative data across two additional dimensions – type of beneficiary institution and type of assistance. First, projects across all sub-sectors were categorized according to the nature of the beneficiary – over the period of analysis 18% of USAID's FSD projects by number and 14% by value were aimed exclusively at regulatory agencies, while 43% of projects and 31% of value were aimed exclusively at market participants, such as banks, NBFIs, stock markets, pension funds, etc. 36% of the projects representing 55% of the total value of FSD authorizations involved both regulators and regulated entities, while a small number of projects (29) representing a negligible percentage of total funds was directed within USAID, for internal training, conferences and other capacity building activities related to financial sector development. Interesting, the percentage of the number of projects *within each subsector* targeted to regulators v. regulated institutions v. both has varied widely. For example, 61% of housing finance projects, 72% of micro, SME and rural finance projects and 77% of other NBFI projects were targeted exclusively to market institutions, with no component of the projects addressing regulators' needs.

It is also interesting – and encouraging – to note that over half of all FSD assistance projects included an institution building component while 40% included training. On the other hand, only 6% of projects included a public relations component and less than 2% of projects addressed the enforcement of regulations – even of the 136 projects that were aimed exclusively at regulatory agencies, only 5 included any work on enforcement.

Finally, the team cross-referenced the ten types of assistance shown above with the seven sub-sectors discussed earlier. While the allocation of assistance types was broadly similar across sub-sectors, there were several interesting anomalies, all of which occurred in the 'pensions and insurance' and 'micro, rural and SME finance' sub-sectors. First, keeping in mind the earlier finding that pensions and insurance accounted for only 5% of USAID's FSD projects over the past 14 years, it should not be surprising to see that 50% of these projects involved an evaluation/assessment component, against an average of only 37% for all sub-sectors – this would seem a prudent response to USAID's relative lack of experience in this sub-sector. While only 4% of all projects involved privatization work, 19% of pensions and insurance projects

included privatization – this probably reflects the trend towards ‘multi-pillar’ pension schemes combined perhaps with the privatization of state-owned insurance providers in transitional economies. Finally, 17% of pensions and insurance projects involved public relations, against a cross-sub-sector average of just 6%. This probably reflects the fact that changes in mandatory pension schemes affect the general population, while changes in areas such as commercial bank regulation or securities markets have a more limited – or at least less obvious – impact on the population.

Only 7% of projects in the micro, rural and SME finance sub-sector included legislative components, only 7% included transparency and only 11% included regulation and supervision. The averages across all sub-sectors for these three assistance types are 14%, 20% and 16% respectively, as seen in the chart at right. In other words, USAID’s allocation of resources suggests that that these three closely related areas are only roughly half as important for micro, rural and SME finance as they are for other sub-sectors. This has probably been true for most of the past fourteen years – emphasis was correctly placed on simply ensuring that financing was made available to microenterprises, farmers and SMEs – but the situation is now clearly changing. In many countries, for example, microfinance institutions (MFIs) cannot collect deposits because they cannot comply with the regulatory requirements for deposit-taking institutions. This inhibits their ability to grow and provide better services to their clients. Moreover, MFIs and SME lending institutions often cannot attract commercial investment because they lack transparency and a stable regulatory/legal framework under which to operate, which also inhibits the growth of the sector. USAID’s Office of Microenterprise Development has recently issued a new Indefinite Quantity Contract (IQC) called AMAP – Accelerated Microenterprise Assistance Project – including an “Enabling Environment” component that can be used to provide technical assistance in building appropriate legal and regulatory frameworks for MFIs, which would also improve transparency.

Office of Emerging Markets

Since 1988, USAID’s Office of Emerging Markets (EGAT/EM) funded 401 projects worth \$243 million. Using the same analyses to EM’s portfolio as was used for USAID overall, we found that EM’s financial sector development activities – which account for about 20% of the total funding, but more than half of the projects – followed broadly similar patterns as those of the Agency as a whole. The division of funds and projects among regions, for example, was almost exactly the same. However, the following exceptions to this general pattern stand out:

- *EM-initiated FSD assistance projects favored least-developed countries more:* 53% of EM’s funding went to lower middle income countries and only 5% went to upper middle income countries as compared to 46% and 10%, respectively, for USAID as a whole. Moreover, 50% of EM’s projects by value were in those countries in the lowest stage of financial sector development, while USAID as a whole spent only 40% of its money in these countries.
- *EM focused more on commercial banking and less on other NBFIs and multi-sector projects:* 33% of EM’s FSD funding was allocated to the banking sub-sector as opposed to 20% of overall USAID funding; conversely, EM spent 3% of its funds on other NBFIs and 17% on

multi-sector projects while USAID as a whole spent 10% and 28% on these sub-sectors, respectively. EM spending on other sub-sectors was in line with USAID overall.

- *EM focused more on evaluation/assessment and less on institution building:* In terms of types of assistance, 57% of EM projects included an evaluation/assessment component, while only 37% of USAID's 761 projects did so. However, only 31% of EM projects involved institution building while 52% of USAID projects did. This divergence might reflect the fact that EM, as a centralized support office, bears greater responsibility for evaluating client country needs and assessing project results, while missions are better placed to offer direct capacity-building assistance to market institutions and regulators.
- *EM has played a leading role in pension and insurance and micro, rural and SME finance:* While EM accounts for only 20% of all USAID FSD spending, 45% of funding for pensions and insurance and 31% of funding for micro, rural and SME finance passed through EM.

Over the past fourteen years, a great deal of assistance has taken place through a number of global or regional contracting mechanisms. In the early 1990s, the Europe and Eurasia (E&E) Bureau launched the Omnibus I and II IQCs. Similarly, EM's predecessor office managed the Financial Sector Development Program I and II from 1988 to 1998 and the IRIS and CAER contracts. In mid-1997, EM introduced five IQCs under the umbrella of SEGIR program (Supporting Economic Growth through Institutional Reform), one of which was for Financial Services. Since SEGIR's inception, some \$196 million in financial sector development assistance has been authorized through its five IQCs, representing 61% of the total for all sectors. Interestingly, of 116 financial sector projects authorized under SEGIR, only 68 were contracted through the Financial Services component. The remaining 48 projects were contracted through a combination of the other four components.

Based on our findings, it is clear that there are a number of opportunities for USAID to heighten its impact on global financial sector development, and it is clear that USAID's central offices like EGAT/EG/EDFS and E&E are well placed to pursue these opportunities and play a stronger coordinating role in the Agency's financial sector development, if they are given sufficient resources to do so.

Other Donors' Financial Sector Technical Assistance Activities

Gillian Garcia, FS Review Team Member, GGH Garcia Associates, provided a summary of the Task 2 report, which provided an assessment of what donors do in terms of strengthening, safeguarding, standardizing and regulating reform of the international financial system as it affects the financial system of developing countries. A detailed breakdown showing the involvement of the players in financial sector development can be found in the report.

Ms. Garcia began by providing an overview of the twenty-six relevant domestic and international players in financial sector development that were reviewed in the assessment. Some challenges ensued in data gathering because these donors currently do not have any internal central databases containing information on financial or technical assistance to financial systems. The

team focused on gathering whatever information they could through annual reports, websites, email requests and telephone discussions.

Financial surveillance encompasses macroeconomic policies and conditions, data collection and dissemination, development of standards and codes, and monitoring of standards and codes. FSAP's and ROSC's are conducted under this area. Ms. Garcia highlighted the different players in this area, along with the extent of their involvement. She then focused on the Financial Sector Assessment (FSAPs) and Review of Standards and Codes (ROSCs) programs. One of the major issues with the FSAP/ROSC is that there are heavy demands on World Bank and IMF staff. The assessments show that there is a great need for pre and post FSAP technical assistance that the World Bank and IMF are not in a position to provide. USAID and other bilateral donors can fill the technical assistance gap if they are allowed access to the FSAP results.

Technical Assistance

There are many players offering similar types of assistance in many of the same countries. The importance of financial services technical assistance is often under-appreciated. Little is known about the efficacy of financial sector technical assistance since it is rarely evaluated.

USAID is a significant provider of financial sector technical assistance. However, it needs more resources than its current allocation of 2.5%. Its all-grant policy is attractive to recipients. Specifically, USAID can help fill the gaps that FSAPs reveal on its own or in cooperation with other donors, through mechanisms such as the FIRST initiative. USAID should do more systematic evaluations and should also follow a planned topology for choosing countries for providing aid.

IFI and Other Donor or Agency Perspectives

Gillian Garcia served as the moderator for the "IFI and Other Donor or Agency Perspectives" panel. Participants included Larry Promisel, co-Chair of the Bank/Fund Financial Sector Liaison Committee, World Bank, Joe Englehard, US Treasury, and Robert Strahota, Assistant Director, International Affairs, US SEC.

Larry Promisel, Co-Chair of the Bank/Fund Financial Sector Liaison Committee, World Bank provided an overview of the Financial Sector Assessment Program (FSAP). The FSAP, a joint IMF and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, work under the program seeks to identify the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses. Currently, 70 countries have voluntarily participated in the FSAPs.

Detailed assessments of observance of relevant financial sector standards and codes gave rise to Reports on Observance of Standards and Codes (ROSCs) as a by-product. To date, 300 ROSC modules have been completed. These assessments are intended as guides for the authorities.

The FIRST Initiative was established as a mechanism to fund technical assistance needs, as highlighted in the FSAPs and ROSCs.

Joe Englehard, Deputy Assistant Secretary of Treasury for Trade and Investment Policy, US Treasury spoke about the Financial Sector Led Growth Initiative (FSLGI), which emphasizes the importance of increasing depth, liquidity and efficiency of the domestic financial sector to achieve growth and sustainability in developing countries. Studies show that liberalizing and deepening the financial services sector, in conjunction with strong legal, supervisory and regulatory institutions, is associated with higher rates of growth through channeling investment to the most productive uses, enhancing capital accumulation, increasing the productivity of investment and minimizing transaction costs through trading of risk, monitoring managers and mobilizing savings. Liberalization means to open domestic markets to FDI in financial services and according foreign and domestic firms equal treatment. This is distinct to opening the capital account. The level of foreign ownership in a financial sector can contribute to crisis avoidance. Foreign bank entry can strengthen the financial sector and increase stability. In fact, foreign entry has been associated with system wide improvements in the quality of regulation and disclosure. The steps to liberalization are to remove any impediments to an open, transparent financial sector and to strengthen supervision or reform regulations to create the right incentives for a growth oriented sector. There are several benefits to liberalization, as were demonstrated in the presentation through the example of the entry of foreign financial service providers in the US. These include: promoting innovations, strengthening the securities market, promoting domestic competitiveness, increasing allocation efficiencies, and providing cost savings to the consumers. The measurements to determine a successful financial sector include quantitative measures, greater access to credit for consumers and businesses and commitments at the WTO. The presentation ended with a comparison of different countries across many factors, indicating that successful markets were more liberalized.

Robert Strahota, Assistant Director, International Affairs, US SEC, explored the trends of global convergence of the financial markets and presented the importance of increasing information disclosure, corporate governance, and financial reporting. The implementation of the FSAP program is geared towards the second component. USAID could direct its efforts towards removing the obstacle to integration, specifically in the markets of the CEE/NIS region. He discussed the importance of securities market development through training of security regulators and stockbrokers. Look at the licensing program for broker/dealers before integration to ensure consistency. In regulation, consolidated supervision across the financial sector is the trend. This makes sense in the small countries because there are not a lot of private organizations. A concern is for banks and NBFIs to be regulated uniformly. A template idea is good; it can help to improve existing markets but not to set up new ones like, for example, in Kosovo, Albania, etc.

Financial reporting is good overall. There are six principles currently highlighted in the FSAPs for financial reporting and they will add a seventh: understandability of reports. Countries are to look to IAS. In the Cancun meeting, the discussion centered on providing oversight of independent auditors, creating a public oversight body.

Keynote Session

Jock Conly, DAA, EGAT Bureau, USAID introduced the Keynote Speaker, Jerry Caprio. He began by commenting on the importance of financial sector reforms in achieving reductions on poverty and sustainable economic growth, supporting one of Mr. Caprio's main arguments. Jerry Caprio serves as the Manager of Financial Sector Research in the World Bank's Development Research Group. He has written extensively on financial sector policy, financial reform and monetary policy. His current research addresses financial crises, and the links between financial sector regulation and the performance of financial institutions. His presentation provides an overview of the importance of addressing financial policy decisions in the central development challenges of the new century.

Gerard (Jerry) Caprio, Director, Operations and Policy Department, Financial Sector Operations Vice Presidency, The World Bank provided an overview of the book, Financing For Growth. As the title, Finance for Growth: Policy Choices in a Volatile World, suggests, we try to identify policies that both maximize the growth potential from finance as well as minimizing the down side, namely, the threat of financial crisis. This book attempts to explain how these policies will work. The bottom line is that the book is urging a rethinking of government's role in finance, highlighting first what governments need to do, such as building the legal and regulatory foundations of the financial sector; what they need to do better, which is working with markets and harnessing incentives; and what they need to do less of, that is, owning banks outright or unduly restricting foreign entry. We also focus on how technology is changing what policymakers can do and how we are moving to a world of finance without frontiers. What matters for growth and poverty alleviation is access to financial services--not who supplies them. The advice in this volume is not deduced from some theory, but rather, from a review of empirical research in recent years, much of it conducted inside the Bank but definitely not all of it, and this is with very large datasets of countries working with anywhere between 60 and 160 countries, depending on the data. So in short, we try to show that finance matters.

Getting finance right we think will contribute to poverty reduction by delivering to all services that are needed to generate growth and absorb the volatility that all economies get at one time or another. I will try to sum up just four messages. First, on what governments need to do--well-functioning financial markets, especially those that are going to supply financial services and credit to small and medium-sized firms, need legal and regulatory underpinnings to boost the reliability of information and ensure that contracts are going to be enforced by a court of law.

Turning next to what governments need to do better, above all, we think that governments have to harness incentives. We think that policy needs to take account of local conditions in emerging markets. The more volatile environment facing developing countries requires that authorities focus on the incentives that are affecting the actors in the system--the owners of the banks themselves, the markets that can monitor them, and the bank supervisors themselves.

Turning now to an area in which we think there is room for less government involvement, although there is much that government needs to do more of, this list does not include owning banks.

We argue that we are quickly moving to a world of finance without frontiers, and countries must decide which financial services they will buy and which they will build at home. As was mentioned earlier, what matters for growth is not who provides the services but the access to those services. Seen against the background of the global financial systems, developing countries are very small indeed. An open financial system is, however, vulnerable to external shocks, but a closed system means that the poor residents there are far more vulnerable to different events at home, such as when the prices of their products fall, as well as policy mismanagement.

Above all, even for countries not ready to open up completely to capital flows, opening up to foreign financial institutions, however politically sensitive it was or still is in countries, has helped strengthen many emerging markets in risk management, credit appraisal, and other dimensions. In finance, government's role is to ensure that the financial sector infrastructure is sufficiently developed and that participants have the incentives to work well together for desired outcomes, which is the prudent supply of financial services to all members of society.

Options for EGAT/EG/EDFS

Teresa Mastrangelo, Director, Deloitte Touche Tohmatsu Emerging Markets, Ltd. gave a few short comments on the options for EGAT/EG, but deferred her allocated presentation time to the implementers, as the previous presentations had run over. However, a summary of her presentation is included in these preceedings.

Ms. Mastrangelo summarized the overall project, describing the findings of the Deloitte team related to each of the four initial tasks undertaken as foundation for the recommendations made in the Options paper. She then described the options for the Office of Economic Growth, with emphasis on the potential global programs to meet EGAT/EG's mandate of providing technical leadership and field mission support for financial sector development activities. Several of these opportunities were mentioned in previous discussions.

1. USAID should use the publicly available output from World Bank/IMF Financial Sector APs as a point of departure for designing its own TA initiatives in some cases. EG might disseminate FSAP reports and work with Missions to design projects— perhaps by developing sample Terms of Reference.
2. USAID might also use the available FSAP results as a part of assessing the impact of its own projects. EG might provide a focal point for standardizing this assessment methodology and applying it across relevant Missions.

3. FSAP-oriented TA activities might lend themselves particularly well to public-private partnerships. For example, twinning arrangements with US banks might be established to help developing country banks learn how to comply with higher regulatory standards. EG could support Missions by helping to facilitate these partnerships.
4. Limited impact evaluations and an apparently random fluctuation of assistance across sub-sectors – together suggest that EG might support Missions by designing and helping implement a standard impact evaluation methodology that can be used as an input into the priority-setting process.
5. USAID should continue to cooperate closely with other donors and take on areas of assistance in which it has a relative advantage.
6. Within USAID, EG can play a strong role in initiating and coordinating regional (cross-national) projects.
7. EG's resources should be used to expand its knowledge management role. For example, as part of knowledge management, staff should update and maintain the database constructed as a part of this study, which lists USAID financial sector projects from 1988 to 2001. EG may use program funds for this work and as well as for enhancement of their current website. A dedicated knowledge manager might be hired.

EG asked Deloitte to identify global trends or issues in financial sector development that might affect the direction of USAID's programs in the near future to supplement the findings of the first four tasks. It is clearly important to understand the issues that USAID's projects might address in future in order to determine how EG can best support those projects. The majority of USAID's financial sector work will continue to be designed and implemented at the country level, based upon specific country strategies developed by the Missions. EG has an important role to play in supporting the Missions' work and helping to ensure the ultimate success of their projects. Specifically, EG has two objectives with regard to supporting the Agency's financial sector development work:

1. *Field Support*
2. *Technical Leadership in New and Existing Programs*

EG might consider initiating global programs that are consistent with its technical leadership mandate. EG might work with Missions to implement pilot projects that address country-specific issues related to the key financial sector trends listed earlier. These projects would likely represent new approaches for USAID, would likely require specialized expertise that might not be available within a given Mission, and could require some research and conceptual work to be performed in advance of a project to identify common problems across countries and develop tools to be used in solving them. OEG is particularly well placed to launch such pilot projects because it can take on greater uncertainty than Missions – assuming its mandate explicitly includes innovation and experimentation with new project designs.

In considering the list of global trends and the possible interventions, above, we suggest below some illustrative projects which meet the criteria for a global program and which OEG might undertake that would be meaningful to many USAID partner countries over the next decade:

- *Financial regulation and supervision.* Based upon an analysis of gaps in assistance conducted to date, OEG could suggest to Missions the scope and content projects, such as consolidated regulation and supervision, surveillance, and enforcement as well as steps countries can take to support the development and reform of the IFA.
- *Compliance with international supervisory standards.* There is a need for extensive training and internships to upgrade supervisory capacity to meet international standards such as the Basle Core Principles or Basle II requirements, which can be done on a broad scale rather than by individual countries. OEG could employ implementers to design and deliver this training, sharing the costs of participation with Missions and with beneficiaries.
- *Rating agency/service development.* Under the new Basle capital adequacy framework, there is likely to be a significant increase in the demand for rating services, providing an additional target of opportunity for USAID work.
- *Regionalization of securities markets.* We propose OEG undertake an initiative to determine how to harmonize or regionalize regulation, supervision, technology, and operations. A technical assistance gap analysis or analysis of the pre-conditions for harmonization could then be used to guide Mission development of statements of work.
- *Prevention of money laundering, terrorist financing, and financial crimes and related law enforcement* are key issues coming to the forefront and most Missions have not integrated these issues into financial sector programs. In parallel with the new World Bank initiative and those of the US Government, in collaboration with interagency partners, OEG could lead the Agency in tackling these issues on a global or regional basis.
- *Expanding markets through e-finance:* Again, this is an area in which OEG could take a technical leadership role in analyzing current research on e-finance, identifying potential interventions and then, assisting Missions to design programs through which they could assist financial institutions to introduce technologies that lower operating costs and that make it possible to provide financial services more widely.
- *Expanding access to finance for SMEs and for the poor:* USAID has funded several large SME finance activities, the impact of which are still unknown. It is now critical for OEG to evaluate and synthesize the successes and failures of these SME projects for future project design.
- *New financial instruments development,* which results in better diversification of products and improved financial intermediation, is another innovative area for USAID.

Ms. Mastrangelo concluded by stating that the scope of EG's role going forward and what level of the activities it may undertake, depends on its resources. The team presented four scenarios to EGAT/EG management to consider. Of those, a scenario in which there are about 4 financial sector specialists in a dedicated unit with about \$2 million of program funds would seem consistent with the objectives of the USAID reorganization to improve support to the Missions.

If, on the other hand, there is a net decrease in financial sector expertise, USAID may have limited its opportunity to solidify the accomplishments made to date.

Implementers' Comments

Alan Batchelder, EWMI, FS Review Team, served as the moderator for a panel of implementers who were invited to comment on the research and findings of the Deloitte team. Speakers from Chemonics, IBM Consulting, Development Alternatives, Inc., BearingPoint and FMI provided their inputs. The comments below of the various implementers are categorized by general theme.

Developing incentives and investing in success:

One implementer noted that the nature of USAID programs has been focused on building capacity and culture. The implementer stressed that developing appropriate incentives are critical to the success of USAID-sponsored programs, and, therefore, should be an area of focus for USAID going forward.

Several implementers suggested that USAID “invest in success”. To this end, they recommended that the Agency develop evaluation criteria and then measure programs against these criteria so that they know what works, what doesn’t work, and, in each case, why. Measuring success is important, but tricky. Therefore, USAID should ensure that it is using the right measurement tools. In this way, USAID can better determine when to continue to invest in an existing program, when to exit an existing program, and when to invest or not invest in a new program or country. If a project is yielding positive results, USAID should leverage this and move forward to the next phase of associated reforms. By doing this, USAID can radiate out. For example, in central banks, once they have addressed bank supervision issues, they could potentially look at the “softer side” of banking issues, such as human resources.

Knowledge Management:

Several implementers noted that knowledge management is another important area where USAID should focus its efforts. Intellectual capital is built but is not disseminated within USAID. This was, in fact, confirmed by the Deloitte team’s findings. USAID needs to be able to leverage information gathered from past projects --- successful and unsuccessful --- and should be organized to gather, process, and disseminate knowledge of best practices and lessons learned for other programs.

SME, Microfinance and E-finance:

One implementer noted their appreciation of the emphasis on globalization and the discussion of E-Finance. The implementer added that they would have liked to have seen more examples of SME finance, which is an intrinsic part of the financial sector. The implementer stressed that new product development is important, although also noted that it is equally important to ensure that new product development is market driven, and not a one-product-fits-all approach. The implementer agreed with the emphasis on public relations, noting that as it is important to sell vision, and suggested that missions should build in more time for public relations, in order to explain proposed reforms, communicate the need for reforms, and build ownership, commitment,

and support for reforms. Without ownership and commitment, no program, regardless of its merits, can be successful. Finally, the implementer supported the idea of more project evaluations, and stressed the importance of setting up an appropriate monitoring and evaluation framework right from the start. Building on the idea of ownership and commitment, this implementer also suggested that consensus building should be considered for a standard performance indicator within the project evaluation framework.

New product development:

Several implementers expressed their support for research project and believed it was a good undertaking for the OEG. One implementer agreed with the new product development ideas and mentioned that past funding in the CEE region had led to successful patterns and themes, which could be used in developing the new products.

Policy coherence, risk management and evaluations:

One implementer analyzed the paper from a policy standpoint and noted that he did not feel that regional initiatives are necessary. The evaluations of USAID programs currently stress ‘lessons learned’, whereas he felt they should be more year-end and mid-year evaluations to determine whether programs are on-track. In this way, if programs are not on track, interventions can be undertaken to set them back on course during the project, rather than waiting until projects end when it is too late to take remedial action. Along these lines, he suggested that USAID should emphasize risk management. He also noted that policy coherence should drive decision making. Further, he suggested that USAID should design a menu of development topology of activities for different countries at different stages of development, in order to build on success, lessons learned, and best practices gained from experiences in other countries at similar stages of development.

SEGIR mechanisms:

All implementers supported the premise behind the SEGIR mechanisms. They noted that these mechanisms enable targeted, rapid, and streamlined responses to key issues. One implementer noted that these mechanisms are in need of better management and administration.

Mission and Bureau Comments

Alan Batchelder, EWMI, FS Review Team, also served as the moderator for a panel of mission and bureau representatives who were invited to comment on the research and findings of the Deloitte team. The following USAID representatives provided comments: Chuck Mohan, LAC Bureau; John Wasilewski, Development Credit Authority (DCA); Skip Kissinger, EGAT; and, Brian Kurz, Global Development Alliance (GDA).

Chuck Mohan, LAC Bureau, USAID, stated that he felt that the recommendations by USAID should be much more firm. USAID needs to focus on making intermediation work better. The beneficiaries need to understand better what USAID does. This is important for successful project implementation by USAID.

John Wasilewski, Development Credit Authority discussed the importance of the Development Credit Authority (DCA) in furthering the objectives of USAID. DCA is the legislative authority that permits USAID to issue partial loan guarantees to private lenders to achieve the economic development objectives in the Foreign Assistance Act of 1961, as amended (FAA). DCA also authorizes USAID to make direct loans. DCA guarantees require true private sector risk-sharing where the USAID share of a lender's risk does not exceed 50 percent (except as otherwise approved by the Credit Review Board (CRB)). DCA permits USAID to offer a mixture of grant and credit assistance in settings where USAID is seeking more disciplined and sustainable assistance relationships. Under DCA, Missions/Operating Units have the flexibility to fund their activities with 100 percent grants, or they can transfer some of their funds to the DCA Account and in effect purchase the right to issue full faith and credit USG guarantees or loans having a value far in excess of the sums transferred.

Skip Kissinger, EGAT Bureau commented on the importance of the peer review process and felt that the conference was very beneficial. He felt that one of the biggest challenges faced by USAID was getting all of the information from the meeting to the missions, since they are the ones who form the projects.

Brian Kurtz, Global Development Alliance, provided a brief overview of the Global Development Alliance (GDA). GDA is USAID's response to the new reality of development assistance that recognizes that flows between the developed world and the developing world have changed. The Global Development Alliance serves as a catalyst to mobilize ideas, efforts, and resources of the public sector, the private sector and non-governmental organizations in support of shared objectives.

General Discussion

Teresa Mastrangelo summarized the major comments from the various panelists on the financial sector strategy report and responded briefly to them.

1. **Limitations of the data from the Financial Sector Assessment Program (FSAPs).** Ms. Mastrangelo acknowledged that much of the output of the FSAP program is confidential, but that nevertheless, missions could benefit from a systematic collection and analysis of the publicly available data in the absence of regular assessments being conducted by the Missions themselves. With declining financial sector resources in USAID Missions, there is a greater need for knowledge to be provided to them from a group such as EGAT/EG.
2. **SME and Microfinance.** One contractor disagreed with the statement made that “SME finance is not intrinsic to the stability or performance of the financial sector.” Ms. Mastrangelo explained that from the perspective of the FS Review team it was necessary to delineate financial sector development from overall private sector development and economic growth for the purposes of their study, even though there may be overlap. From the team’s perspective, SME finance is a separate discipline and the results sought in microfinance projects and SME finance projects are not the development of the financial sector, but rather, are income generation and employment growth.

3. **Policy coherence.** One commenter made the statement that what was needed from EGAT/EG was a coherent financial sector policy which set targets for Missions worldwide and that, perhaps, was a fifth scenario to the four presented in the report. Ms. Mastrangelo agreed that policy coherence was critical and commented that the expression “policy coherence,” was perhaps a more appropriate way to refer to the suggestions in Scenarios B and C.
4. **Non-humanitarian assistance.** Another commenter had made the point that the list of global programs made in the report was perhaps too sophisticated for the needs of some of USAID partner countries. Ms. Mastrangelo pointed out that in fact, the role of EGAT/EG was to be ‘out-in-front’ and provide technical leadership, and, accordingly, should more likely propose sophisticated solutions to financial sector development problems. Nevertheless, she did agree with the vital role that USAID plays in providing non-humanitarian assistance, particularly in post-conflict countries, and committed to revision of the report accordingly.

Wrap-up and Adjourn

John Carihfield, SEGIR Financial Services Component Manager, USAID, wrapped up the conference by thanking all of the moderators, speakers, and participants. He thanked the Deloitte team for a job well done and encourage everyone to take what had been learned from the conference to further improve the programs offered by USAID.

ATTENDEES

**LIST OF ATTENDEES
FINANCIAL SECTOR REVIEW AND STRATEGY**

**Wyndham City Center
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Bank Resolution

**United States Agency for International Development
SEGIR – Financial Services
Review and Evaluation**

**December 11, 2002
Washington, DC**

□ **Why is it important?**

□ **What does it entail?**

□ **Our Experiences**

□ **Lessons Learned**

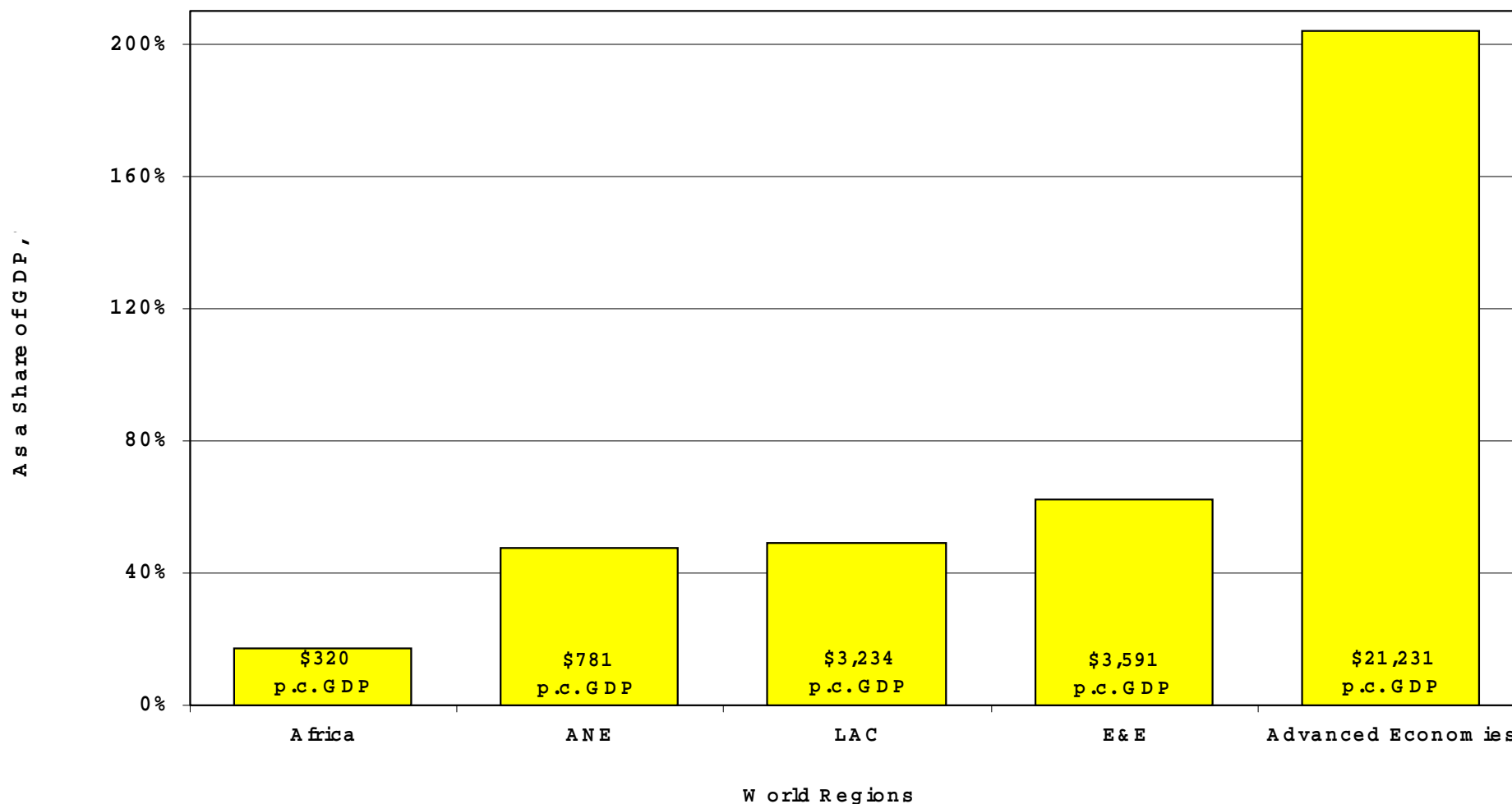
- **Sustainable economic development hinges on a healthy financial sector and in most developing countries, banks dominate the financial sector**
- **Often, banks are unable to function properly**
 - Due to an underdeveloped environment; and/or
 - A heavy burden of non and sub-performing assets

Unhealthy financial institutions impede efforts to achieve sustainable economic growth and prevent other financial sector reforms from fully achieving intended results

Banking Assets and GDP per capita



Total Bank Assets as a Share of GDP, 1999
-select USAID countries -



Note: Nonweighted Average of Select Countries per USAID Region.

Source: FDI; MF International Financial Statistics; Economist.

Key Components for a Healthy Financial Sector



□ Prevention

- Bank Supervision and Regulation – presentation by Lori Bittner, FSR Group of BearingPoint

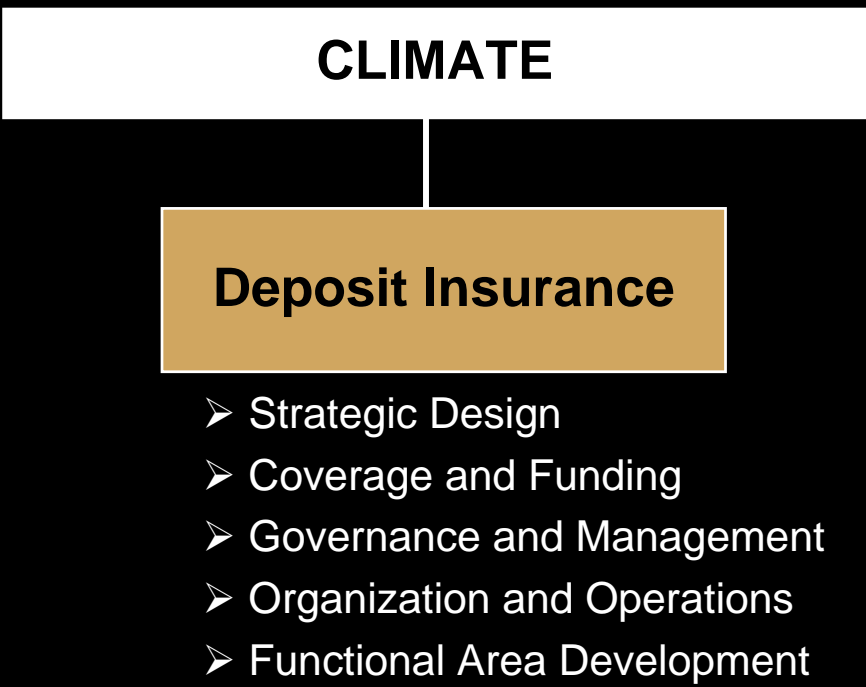
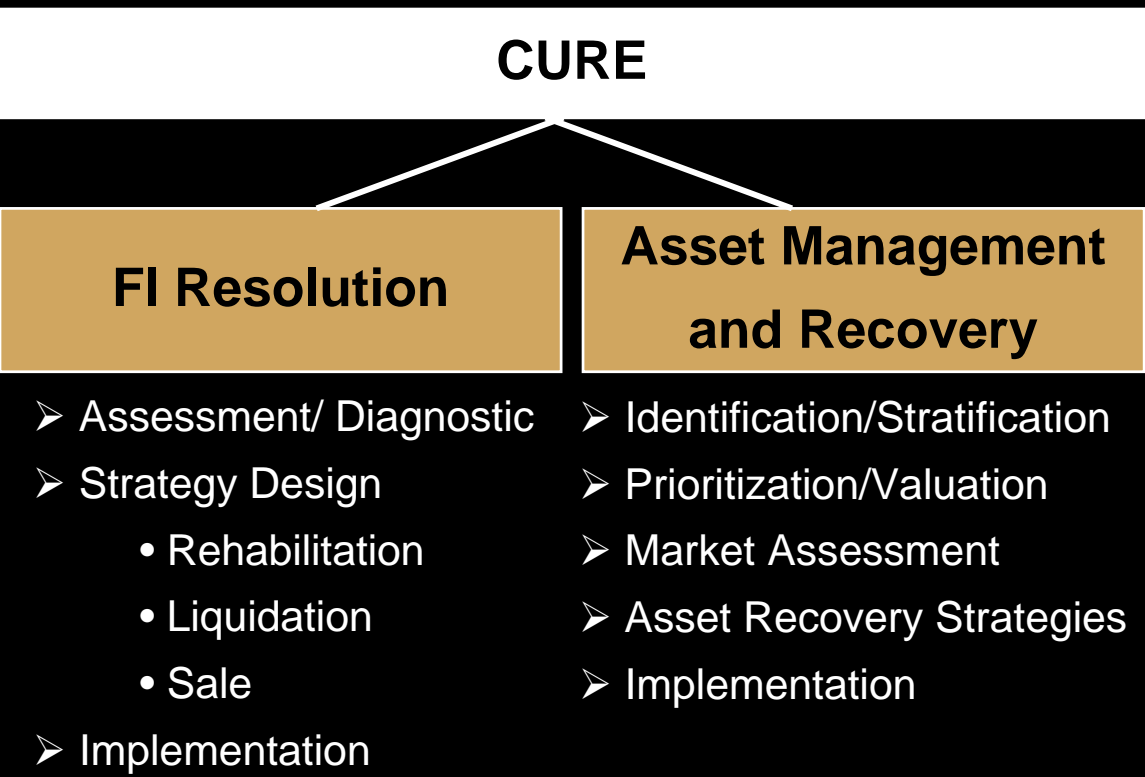
□ Cure

- FI resolution strategy consistent with government objectives
 - Credible exit strategy for failing banks
- Realistic process for managing distressed assets and recoveries

□ Climate

- Confidence
 - Bank Depositors – Deposit Insurance
 - Bank Creditors and Investors
- Creditor rights
- Market competition and discipline

Our Resolution Solutions



Public Education	MIS/IT	Accounting & Reporting	Oversight
SUPPORT FUNCTIONS			

USAID Resolution Engagements



Project	Bank Rehabilitation & Privatization	Asset Management & Recovery	Problem Loan Workout	Deposit Insurance
Bulgaria *	✓	✓	✓	✓
Croatia	✓	✓	✓	
Poland	✓	✓	✓	
Slovakia *	✓	✓	✓	
Bosnia & Herzegovina *	✓	✓	✓	
Romania	✓	✓	✓	✓
Yugoslavia - Montenegro and Serbia *	✓	✓	✓	✓
Armenia	✓	✓	✓	✓
Ukraine	✓	✓	✓	
Ecuador *	✓	✓	✓	✓
Kazakhstan *	✓	✓	✓	✓
Indonesia *	✓	✓	✓	✓

*** FS SEGIR Projects**

Tangible Results and Benefits



Cure - Resolution

- ❑ Feed-back loop for supervision to understand what went wrong
- ❑ Recycle “distressed” assets into productive use
- ❑ Impose real market discipline for bank management and debtors
- ❑ Prevent erosion of safety and soundness principles
- ❑ Effective resolution allows future failures to be contemplated – some failures are good

Climate - Deposit Insurance

- ❑ Increased depositor confidence
- ❑ Decreased government exposure – eliminate/reduce guarantees
- ❑ Increased market discipline for bank creditors

Lessons Learned

- Emphasize Capacity Building
- Provide Sufficient Hands on Training
- Engage Private Sector
- Early Involvement

Allow Time to Build Institutional Capacity for Credible Resolution



- **Local buy-in on resolution takes time to achieve**
- **Implementing resolution programs is not a substitute for capacity building – TA should support both**
- **Delivering manuals is ineffective without counter-part involvement and ownership – sense of accomplishment**

Success: Slovakia Asset Sale, Bulgaria Deposit Insurance

Provide Sufficient Hands-On Training



- **TA should allow for testing of the resolution strategies and procedures**
- **Advisory support should entail test cases – these test cases take time to play out and for the iterative process to work**
- **Identify and include all key players in the process**
 - Government Officials
 - Relevant Agencies
 - Private Sector
 - Judges

Success: Slovakia Asset Sale, Bosnia Bank Resolution

- **Private sector bankers and businessmen know what the barriers to success are. Tap their knowledge to develop solutions. Test solutions with them.**

Success: Slovakia Asset Sale

Get Involved Early



It is easier to implement an appropriate systemic resolution approach if assistance is provided early on. Otherwise, assistance ends up as “damage control” or working within a structure that is far from optimal.

Success: Bulgaria Deposit Insurance, Indonesia Deposit Insurance

Q & A

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Financial Sector Supervision and Regulation: Getting Systems to Work

**United States Agency for International Development
SEGIR – Financial Services
Review and Evaluation**

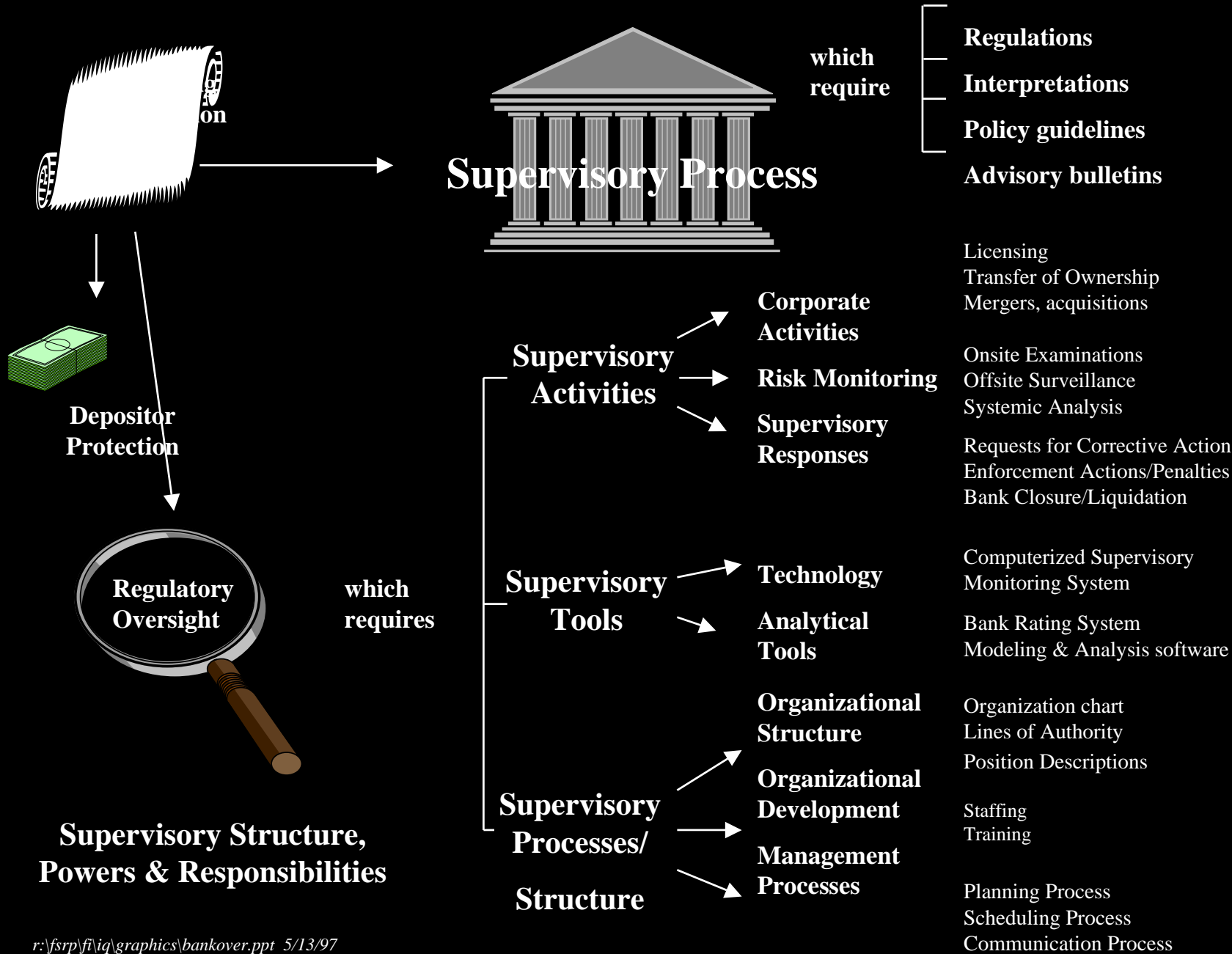
**December 11, 2002
Washington, DC**

Why is Supervision of the Financial Sector Necessary?



- Role banks play in the economy
- Need for public confidence
- Protection of depositors
- Systemic stability
- Promoting competition, fairness and efficiency

Components of Supervision



Central Financial Sector Issues-- Challenges



- ❑ Legal framework not adequate and necessary powers not provided to regulatory agencies
- ❑ Compliance culture
- ❑ Human constraints
- ❑ Inadequate processes and organizational structures
- ❑ Antiquated information systems
- ❑ Insufficient understanding of financial sector, services, competition

Sustainable capacity building---

Through institutionalization of a banking supervisory culture

- **Public, industry and political acceptance**
- **Independence and adequate organizational structure**
- **Availability of accurate information and information systems/technology**
- **Skilled personnel**
- **Appropriate laws, rules and judicial framework**

Lessons Learned—What works?



- International ‘Best Practice’ are guide but no one model to success
- Must obtain counterpart trust and ‘buy-in’
- Strengthening the financial sector is a long-term endeavor
- Bank supervision can not be done in a vacuum—impacts political, social, and economic platforms
- Successful programs help strengthen both the supervisory agency and the financial sector simultaneously

Lessons Learned—What works?



Poland— trust, long-term relationships

Serbia— U.S. Study tours

Bosnia— Joint working groups; IFI collaboration

El Salvador and Ecuador— Counterpart buy-in and input

Moldova— Ownership of assistance-Offsite Surveillance

Uganda— Coordination of other donors

West Bank/Gaza-- Ability to adapt to changing environment

Impact -- Future Suggestions



Programs must be designed to allow for the cultural change that is necessary to take place—long-term effort

Ability to measure successes is not always immediately apparent

Experiences gained through USAID bank supervision programs around the globe should be used to ‘jump-start’ supervision of other financial sector players (i.e., NBFIs, insurance companies, pension, etc.)



Non-Bank Financial Institutions: Regulation For Development

USAID SEGIR Annual Meeting

11 December 2002

Anthony Sinclair
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**Deloitte
Touche
Tohmatsu**

Overview

- **Why are NBFIs Important?**
- **Where are they in development?**
- **Assumptions for NBFI Regulation**
- **Framework for Supervision**
- **Lessons Learned**
- **Mauritius – Regulation for Development**

Why Are NBFI's Important?

NBFI's	Role in financial sector ...
Insurance (Life and General)	<ul style="list-style-type: none">▪ Household Stability▪ Savings Mobilization▪ Transfer Risk - Support Trade/Commerce
Mutual/Pension Funds	<ul style="list-style-type: none">▪ Savings Mobilization▪ Resource Allocation▪ Add Depth/Liquidity to Financial Mkts
Securities Markets	<ul style="list-style-type: none">▪ Alternative Intermediation▪ Spur Competition▪ Savings Mobilization
Brokers/Dealers	<ul style="list-style-type: none">▪ Execute Transactions▪ Market Make▪ Add Liquidity
Credit Coops/Finance Cos/Leasing	<ul style="list-style-type: none">▪ Alternative Sources of Finance▪ Under-served Niches/Areas▪ Broaden Financial Markets

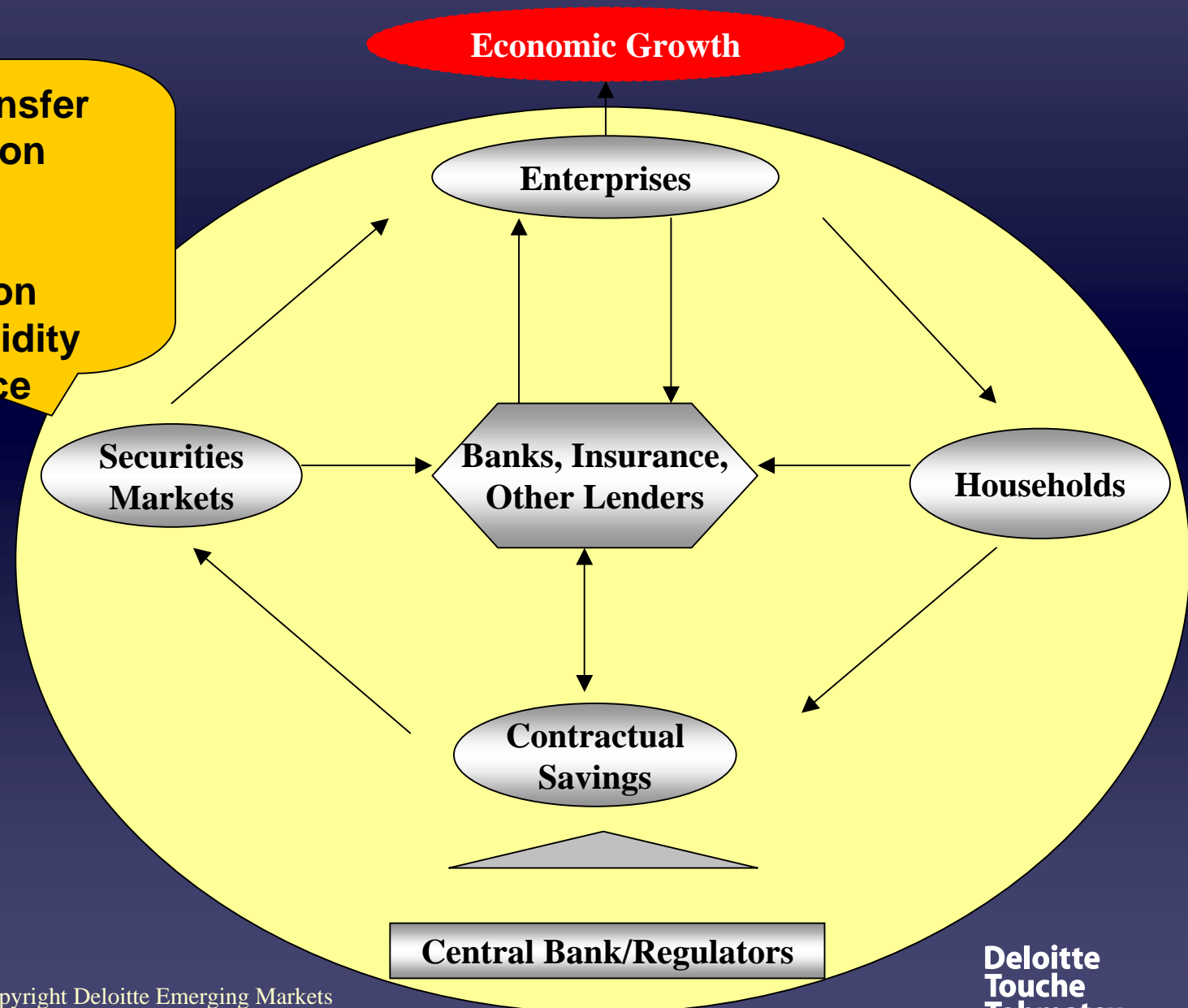
Financial Intermediation at 10,000

ft.

NBFIs ...

- ✓ Risk Bundling/Transfer
- ✓ Savings Mobilization
- ✓ Alternative Intermediation
- ✓ Resource Allocation
- ✓ Market Depth/Liquidity
- ✓ Specialized Finance

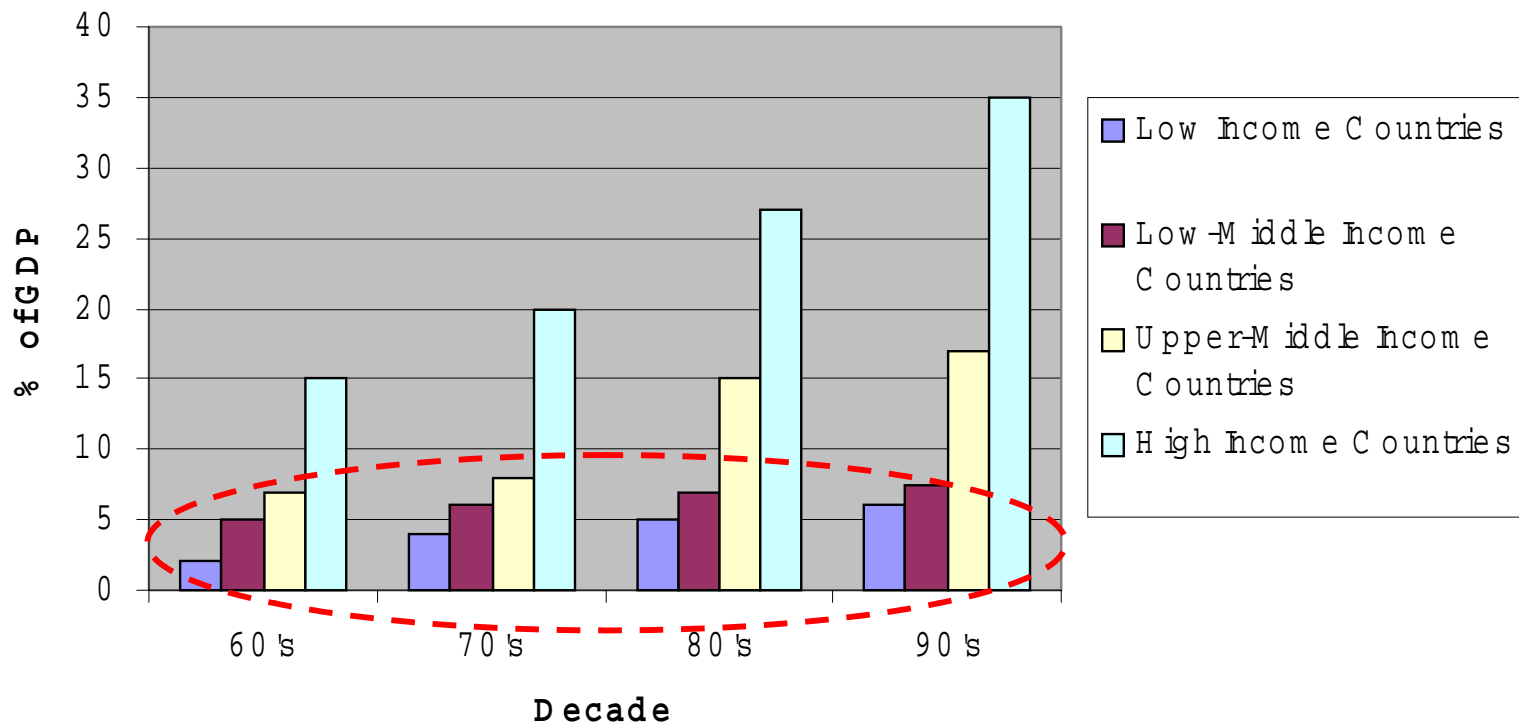
“Spare Tires”
contribute to
stability



Relative Position of NBFIs Around the World

Role/importance of banks diminish somewhat as economies grow

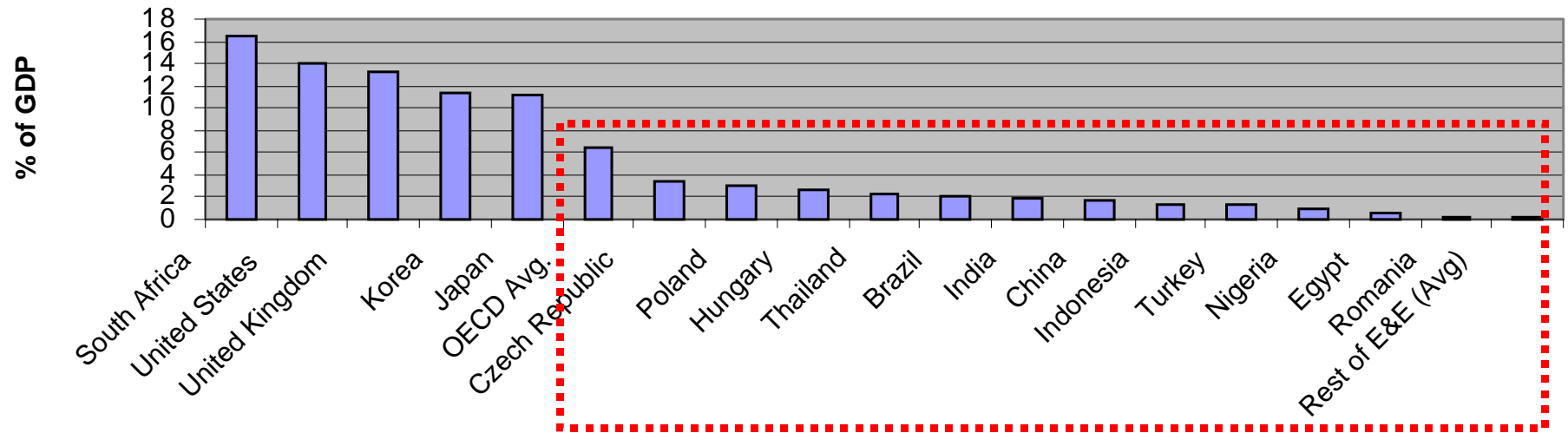
Claims By Non-banks Towards Private Sector/GDP (Cross-Section of 155 Countries)



Source: OECD, Demirgüç-Kunt & Levine

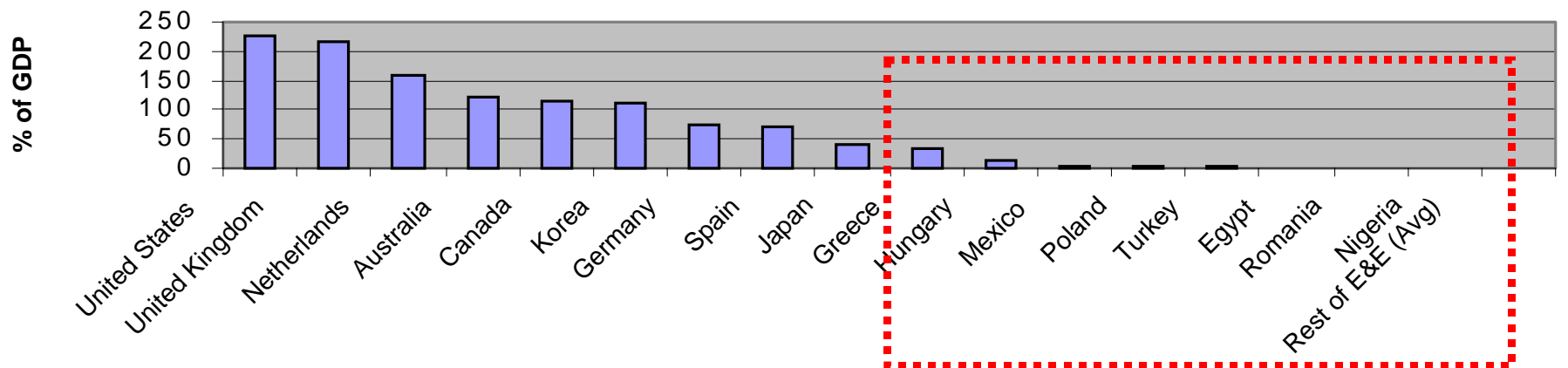
Penetration of Insurance and Contractual Savings

Penetration of Insurance (Life and General)



OECD

**Financial Assets Held By Contractual Savings Institutions
(Pensions, Life Insurance, Mutual Funds)**



Development Factors

Varied, inter-dependent, and different than for banks

NBFI's	Development Factors
Insurance (Life and General)	<ul style="list-style-type: none">• Savings, mkt depth, inflation, other vehicles• Tax policy, pension policies
Mutual/Pension Funds	<ul style="list-style-type: none">• Existence of govt pension/safety nets, depth of stock market• Market integrity• Tax incentives
Securities Markets Brokers/Dealers	<ul style="list-style-type: none">• Depository, trading system, clearing/settlement• Disclosure, conduct of business, clear mandate• Institutional investors
Credit Coops/Finance Cos/ Leasing	<ul style="list-style-type: none">• Sources of wholesale finance• Market-oriented legal framework, regulatory gaps• Reach of banking system

Some Differences Among Regions

- Bank-based systems
- Weak legacy of NBFIs services
- Some growth, but slow development

- Strong (arbitrage) growth, but under-regulated.
- Contributed to crises in Thailand, Korea, Malaysia, Japan

- NBFIs evolved to fill gaps in bank-based systems (inflation and reach)
- Legacy of state-ownership
- Systemic underdevelopment



Development can go wrong ...

Thailand	<ul style="list-style-type: none">• Systemic risk from finance companies were catalysts of crises.
Singapore	<ul style="list-style-type: none">• Barings collapse from unauthorized trading by subsidiary.
Japan	<ul style="list-style-type: none">• Strain on banking system from finance company subsidiaries.
Korea	<ul style="list-style-type: none">• Merchant banks and trust funds as secondary banks• Leasing and life insurance as secondary banking systems
Brazil/Philippines	<ul style="list-style-type: none">• Pre-need institutions go unregulated yet extend commitments many years into future.
United States	<ul style="list-style-type: none">• LTCM collapse over derivatives leverage rocked the financial system for days.
Albania	<ul style="list-style-type: none">• Failed pyramid schemes put country in crises

Regulatory Issues

- **Historically, no coherent approach to NBFi regulation (different roles; different risks; different perceptions; patchwork evolution)**
- **Regulation towards application of individual laws created in a policy/sector strategy vacuum.**
- **Capacity-building reform around skill-building, organizational design and standards implementation.**
- **Enforcement mechanisms weak and inflexible**
- **NBFi development sensitive to regulation – burden vs. efficiency**
- **Role in money laundering under scrutiny ... these days**

Important Assumptions for NBFI Regulation Design

- **Neutrality** in regulation among financial intermediaries is key to avoid unsound/fettered development.
- Not all institutions need to be regulated alike
- Intensity of supervision should be *scaled* by the degree of risk
- **Coordination** of regulation towards different objectives
- The **incentives** have to be in line.
- Effective regulation is **holistic**.
- Regulation should not seek to avoid all failure – **tolerance** limits driven by policy

Integrated Framework for Regulation

Set Objectives

Objectives (Indicative)

- ✓ Safety and Soundness
- ✓ Market Integrity
- ✓ Protect Users of Fin Svcs
- ✓ Other Policy Decisions

Principles

- ✓ Neutrality
- ✓ Proportionality
- ✓ Cost Effective
- ✓ Leverage Mkt Discipline
- ✓ Leverage Self-Regulation

Design Tools

Prudential Standards

Enforcement
Regime

Market Conduct Rules

Disclosure

Market Structure
Requirements

Entry Requirements

Apply Regulation

Regulate Towards Objectives

Securities Markets

Insurance Markets

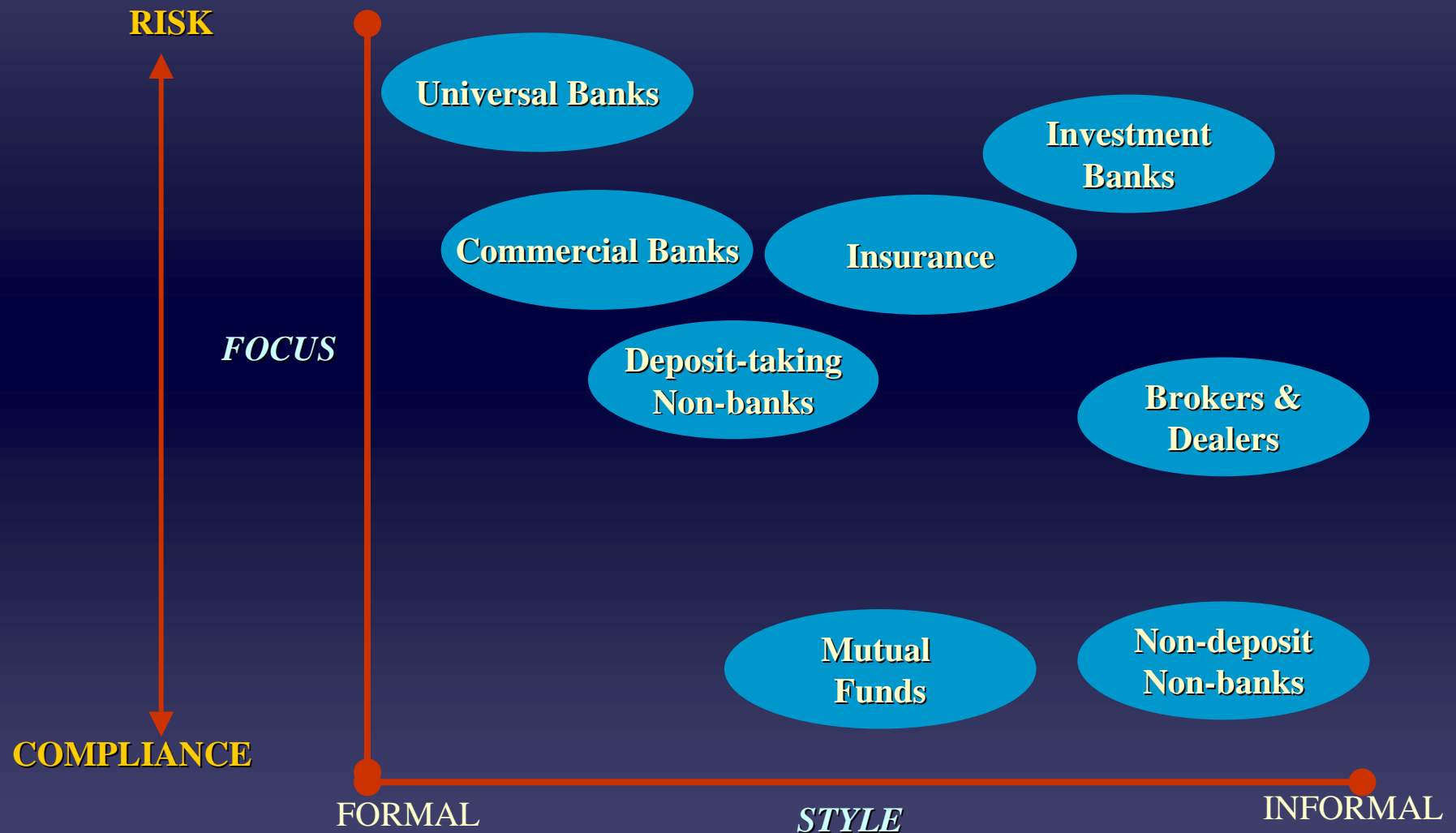
Contractual Savings

Other NBFI

Banks

Intensity of
Regulation

Calibrated Supervision (Indicative)



Implementing TA: Lessons from Practice

- **Policy coherency**
- **Address root causes**
- **Consensus build (industry consultation, MOU, stakeholder map)**
- **Develop a rigorous (sound policy-based) framework for sequencing**
- ***Train* – don't just educate**
- **Build in more routine assessment of progress**
- **Engage counterparts from Day One**
- **Be Activist**
- **Tailor the approach - one size does not fit all**

Implementing TA: Discernable Needs of Donor Countries

- **Policy setting and objective setting**
- **Developing coherent frameworks for regulation**
- **Best Practice Standards for Integrated NBFIs**
- **Policy frameworks for harmonization**
- **Public consultation process**
- **Supervisory cooperation agreements**
- **Enforcement mechanisms**

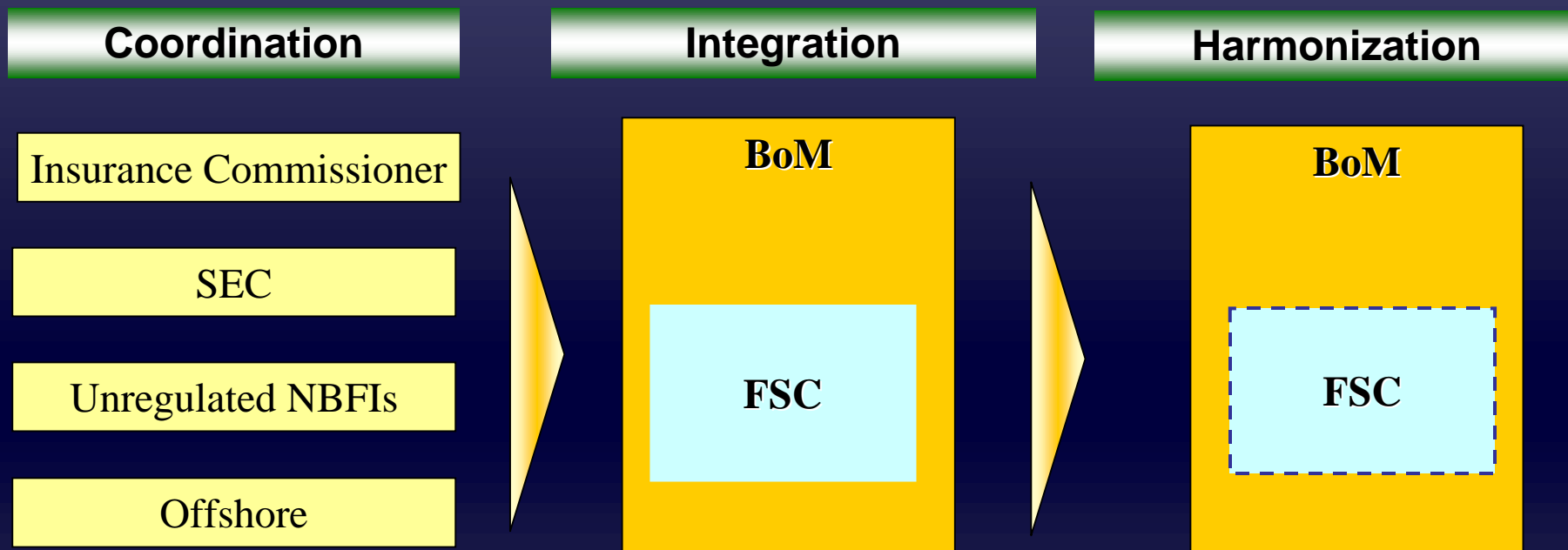


Case of Mauritius

Creation of an integrated NBFI regulator

- **Broaden economic base in FS to serve region**
- **Fill regulatory gaps in NBFI sector**
- **Fill regulatory gaps in offshore industry**
- **Harmonize regulatory process among banks and NBFIs**
- **Develop FS promotion agency**

Program Phases





Business Consulting Services

Financial Sector Annual Review and Strategy Forum

**Capital Markets: Building
Financial Sector Infrastructure**



Challenges Faced by Developing Markets

- Small markets, small size companies, low volumes of financial transactions
- Disincentives for public companies – high costs, no clear benefits
- Dominance of private transactions
- Low liquidity and few products
- High transaction costs
- Lack of regulatory transparency and enforcement
- Low information efficiency--weak disclosure and little dissemination
- Weakness of institutional investors to push corporate governance
- Low public (retail) participation level
- Capital flight
- Sustainability of stock exchanges and brokers uncertain

Scope of USAID Assistance in Capital Markets -- SEGIR FS/Transition Economies

- **Legal reform**
 - Develop securities market legislation

- **Regulatory capacity**
 - Develop regulations
 - Build institutional capacity, training

- **Trading platforms and clearance and settlement systems**
 - Establish Stock Exchanges (incl. technological infrastructure)
 - Establish C&S Infrastructure

- **Self Regulatory Organizations**
 - Assistance to SRO formation and capacity building

Results - SEGIR FS Projects in Armenia and Macedonia

- **Legal reform**
 - Lengthy, political, unpredictable timing and results – nevertheless successes in both countries
- **Regulatory capacity**
 - Quality of regulator depends on leader, political landscape
 - Enforcement an issue
- **Trading platforms and clearance and settlement systems**
 - Assistance in the establishment of the Stock Exchange in Armenia
 - Smart investment in technology – leverage USAID owned systems
 - Support for regional integration efforts in Macedonia
- **Self Regulatory Organizations**
 - Mixed record

Scope of USAID Assistance – Outside SEGIR FS

- **Philippines – USAID AGILE project**
 - Assistance to the regulator – enforcement, training
 - SRO – Assist in the establishment of a new Fixed Income Exchange

- **India – USAID FIRE project**
 - Assistance to the regulator – surveillance, restructuring and training, STP and T+1 issues
 - Establishing securities market law programs at institutions of higher education

Lessons Learned – USAID Capital Markets Projects

- **Legal reform**
 - Imperative
 - Coordinate with WB, IMF to help focus the government
- **Regulatory capacity**
 - Need to leverage local champions
 - Capacity building is a continuous “work in progress”
- **Trading platforms and clearance and settlement systems**
 - USAID investments in technology were a result of mass privatization - further investments improbable except for “early stages” markets
 - Further advisory needed to avoid systemic risks
- **Self Regulatory Organizations**
 - Progress very slow in “early stages” markets – donor patience required
 - Extensive support warranted when counterpart commitment in place

Global Trends and How They Affect Developing Markets

- **Liberalization of cross border investment flows**
 - Regulatory challenge, competition for capital and for customers, higher standards, capital outflows
- **Consolidation of financial services firms**
 - Regulatory challenge, competitive challenge for domestic financial intermediaries, higher standards
- **Expansion of financial instruments (securitization, derivatives)**
 - Regulatory challenge, risk management issues
- **Harmonization of disclosure (GAAP, IAS requirements)**
 - Regulatory challenge, pressure to implement higher standards
- **Active corporate governance**
 - Regulatory challenge, pressure to implement higher standards, to change regulations and practices

Financial Market Reform Going Forward: Approach

- **Build regulatory framework**
 - **Build/strengthen Regulators**
 - **Assist in the establishment of effective SROs**
- **Help develop industry skills (“early stages” markets)**
- **Implement international standards and best practices**
- **Coordination with WB/ADB/IADB for policy/conditionalities and with IFC and EBRD for direct financing of capital for private sector initiatives**

Financial Market Reform Going Forward: Interventions/Projects

- **Integrated Interventions/Projects – to include:**
 - **Strengthening the Regulators’ capabilities**
 - **Assistance to Intermediaries**
 - To increase level of professionalism – “early stages” markets: Armenian NBF Incubator
 - To develop effective SROs (training, certification, international standards)
 - **Implement pension and insurance reform**
 - Help build regulatory framework and regulators
 - Help develop industry skills – “early stages” markets
 - **Corporate governance**
 - **Drive reform of business environment: transparency, anticorruption, anti-money laundering**

- **Project mix dictated by:**
 - **Country level of development and political situation**
 - **Existence and jurisdiction of local champions**

Conclusions

- Main focus of financial sector interventions should be the development of a proper regulatory framework
- Integrated projects should be designed with optimal mix of components dictated by the country specifics



Pension Reform: Opportunities and Challenges for USAID

USAID Financial Sector Review and Strategy Forum

December 11th, 2002

Today's Discussion

- 1. The Importance of Pension Reform**
2. Recent Trends and Key Issues
3. Opportunities and Challenges for USAID
4. Potential Approaches – Example from India
5. Suggested Next Steps

Objectives of a National Pension System

Avoid future social costs associated with a large number of elderly poor

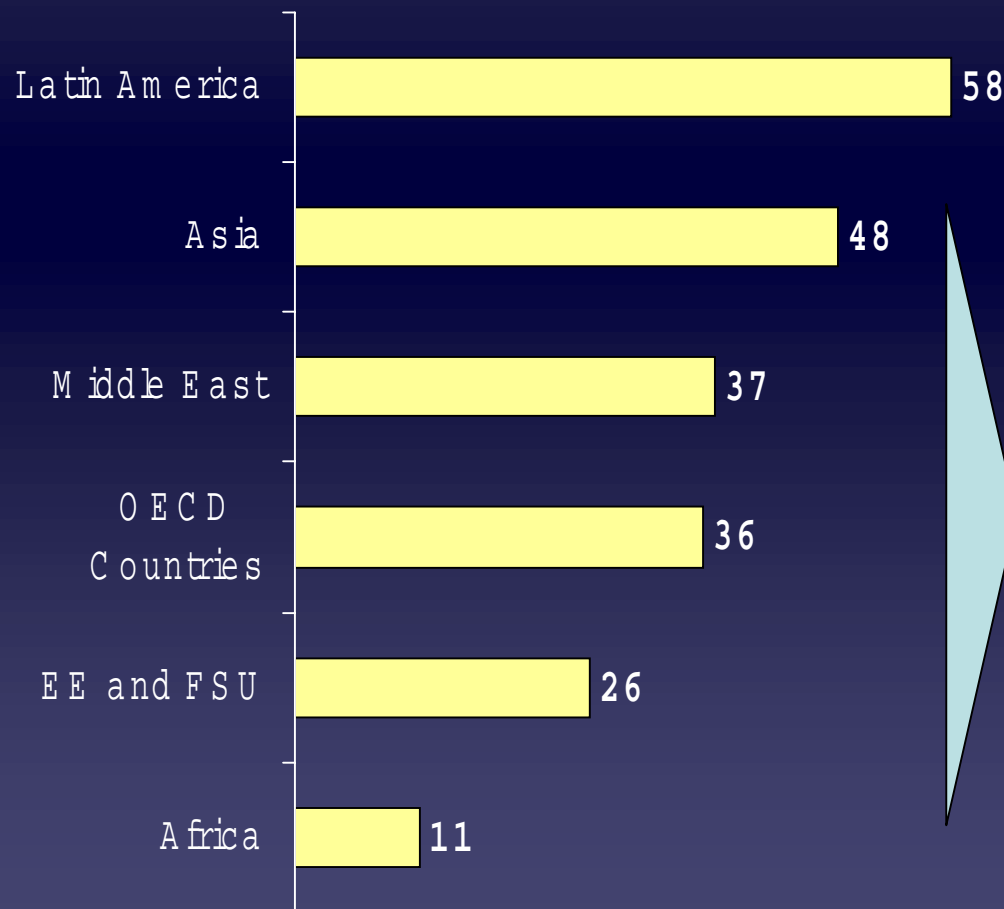
- **Income:** Ensure adequate retirement income to system participants
- **Coverage:** Achieve full coverage of an appropriate target group
- **Sustainability:** Maintain long-term financial sustainability of the system
- **Growth:** Support (or at least do not hinder) general economic growth

Risk Management!

Demographic Drivers of Pension Reform

Percentage Increase in Percent of Population Over 60, 2000-2020

By Region....



...And for Selected Countries

Cambodia	80%
Thailand	73%
Brazil	70%
China	57%
Indonesia	49%
Azerbaijan	46%

Source: World Bank staff estimates

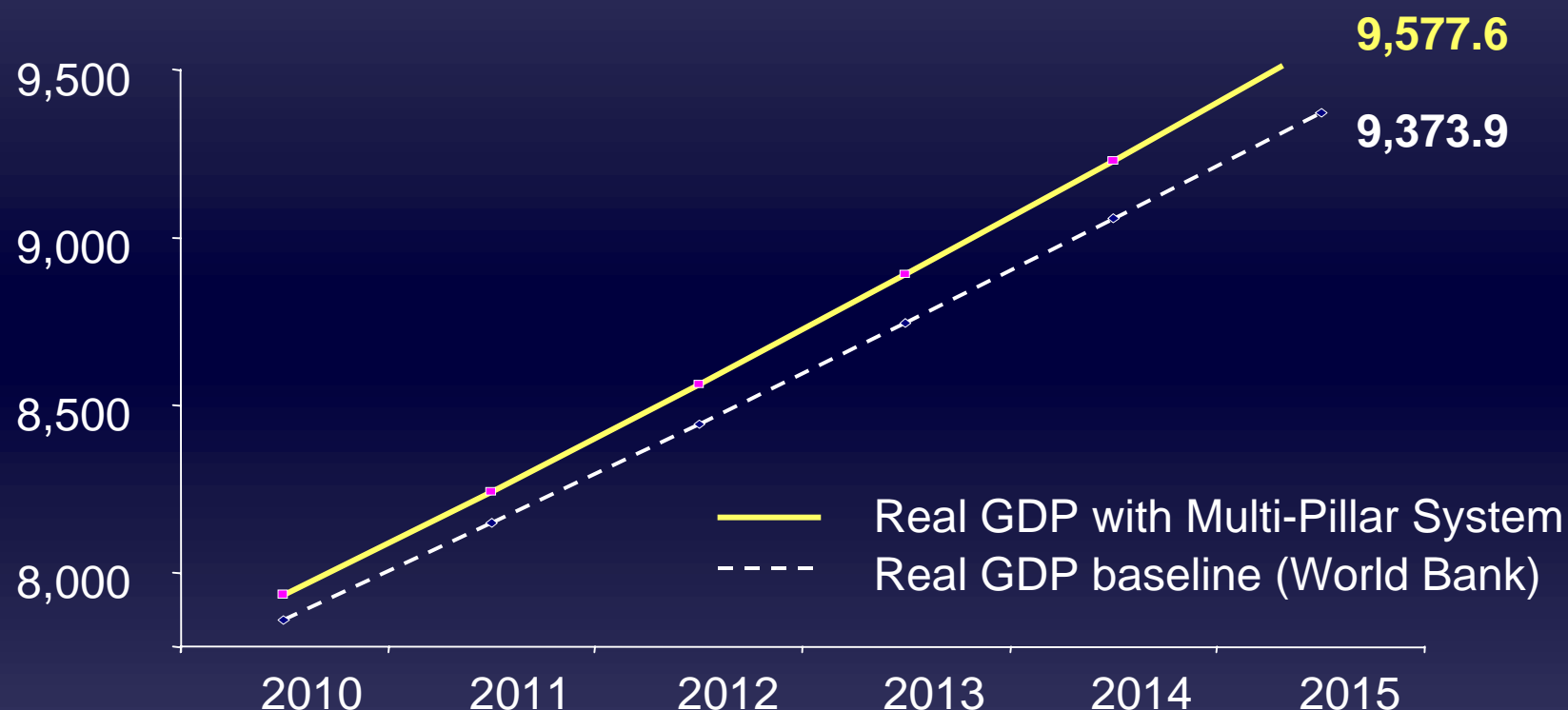
High Social Costs of Pension ‘Mistakes’

Poorly Designed, Regulated or Managed Pension Programs Can...

- **Crowd out private savings and investment:** In India, \$9.5 billion in mandatory contributions (10% of participants' salaries, 2% of GDP) are invested only in government instruments and state-owned companies.
- **Strain government budgets:** In Uganda, annual liabilities for civil service pensions alone are larger than the annual budget for health care.
- **Cause civil unrest:** Trade unions in Korea collected 2 million signatures and threatened to boycott social security contributions over a mismanaged expansion of mandatory coverage to the self-employed.
- **Redistribute wealth from the poor to the rich:** In the US, the collapse of Enron bankrupted many workers' retirement plans; in Thailand, general tax revenues are used to contribute to civil servants' pension plans.

Potential Benefits of “Getting it Right”

Sample Projections from Thailand: Estimated Potential GDP Growth



Also, Chile claims its reformed pension system has resulted in: 1) higher productivity of capital, 2) more efficient capital markets, 3) new financial instruments, and 4) improved standards of corporate governance...

Today's Discussion

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Types of Pension Programs

National pension systems can have one or more of these elements...

Pillar I	<ul style="list-style-type: none">• Government-sponsored, mandatory social security pension program• Often contributory, defined benefit, financed on a pay-as-you-go basis• At times a flat-rate pension, income tested, based on residency, and/or paid from general revenue
Pillar II	<ul style="list-style-type: none">• Mandatory, defined contribution, individual account pension program, usually invested by private pension fund management companies• Usually allows choice of investments by individuals or employers
Pillar III	<ul style="list-style-type: none">• Contributions can be taxed at time these are made or at time of claim• Any voluntary retirement savings plans, sponsored either by employers or by individuals

• In some countries, voluntary contributions are made by individuals to the same pension fund management companies as the Pillar

Risk Management!

Relative Advantages of Each Pillar

In a multi-pillar model, disadvantages are offset by other Pillars' advantages.

PILLAR	TYPICAL ADVANTAGES	TYPICAL DISADVANTAGES
Pillar I	<ul style="list-style-type: none">• Income redistribution• Quick pension generation• Index pensions to inflation• Relatively simple to administer• Less need for complex administration	<ul style="list-style-type: none">• Inadequate benefits• Weak contribution/benefit link• Vulnerable to demographic shocks• Vulnerable to political pressures• Subject to wage manipulation
Pillar II	<ul style="list-style-type: none">• Strong benefit/contribution link• Insulated from demographic shocks• Can increase savings / investment• Can strengthen capital markets	<ul style="list-style-type: none">• No redistribution or poverty alleviation• Long time required to pay full pensions• Unpredictable pensions not indexed• Complex to administer and regulate
Pillar III	<ul style="list-style-type: none">• Adaptable to diverse employer needs• Simple and inexpensive to administer• Limited government involvement• Reinforces individual accountability	<ul style="list-style-type: none">• No redistribution or poverty alleviation• Difficult to index pensions to inflation• Difficult to expand to smaller employers• Limited labor mobility

Current Issues in Pension Reform

The general trend is away from Pillar I towards multi-pillar systems...

- **Defined contribution instead of defined benefit**
- **More private management of assets (instead of government control)**
- **Greater individual choice in contribution and investment decisions**
- **More funding of mandatory pension plans**
- **New ways to blend pillars and provide minimum guarantees**
- **Coverage for the poor, self-employed and informal sector workers**
- **“Second generation” technical assistance – compliance and enforcement, anti-money laundering, governance, etc.**

Today's Discussion

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2. Recent Trends and Key Issues
3. **Opportunities and Challenges for USAID**
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Potential Opportunities for USAID...

What does USAID have to offer in pension reform?

- Many USAID client countries are in need of assistance
- Fits with strategic objectives: strengthen financial markets, foster private sector growth, alleviate poverty, build institutional capacity, etc.
- Can link into and support activities in related intervention areas
- *USAID advantages:*
 - ✓ able to provide substantial amounts of grant assistance
 - ✓ access to a wide range of external and internal expertise
 - ✓ can provide the “whole package” of assistance
 - ✓ can get engaged LT with dedicated in-country teams

...And Key Challenges

What challenges and pitfalls will USAID face?

- To be effective and sustainable, pension reforms cannot lead -- should follow basic, multi-sector interventions
- Highly political, many vested interests
- No magic pill - each solution must be tailored
- Impacts hit many other sectors: to capital markets, anti-money laundering, corporate governance
- Impact on poverty alleviation is not obvious: requires careful consideration and appropriate interventions, as well as proactive “public relations” to ensure continued political support

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Project Background

Pension Reform in India: Initial Needs Assessment

In August 2001, Deloitte was contracted by USAID/India to undertake a comprehensive assessment of the pension sector in India. This assessment focused on five areas:

1. Legal, policy and regulatory framework for private pensions
2. Pension system for civil servants
3. Advocacy, education and consumer protection
4. Training and research
5. International donor initiatives related to pension reform

Objective:

To help USAID/India understand the pension sector, and determine which, if any, interventions should be included in the new country strategy.

Our Approach to the Project

A Structured, Objectives-Driven Methodology

Step 1:

Evaluate existing pension programs against objectives: income, coverage, sustainability, and growth.

Step 2:

Identify gaps, from which develop a “long-list” of potential areas for intervention

Step 3:

Evaluate intervention options using established screening criteria

Step 4:

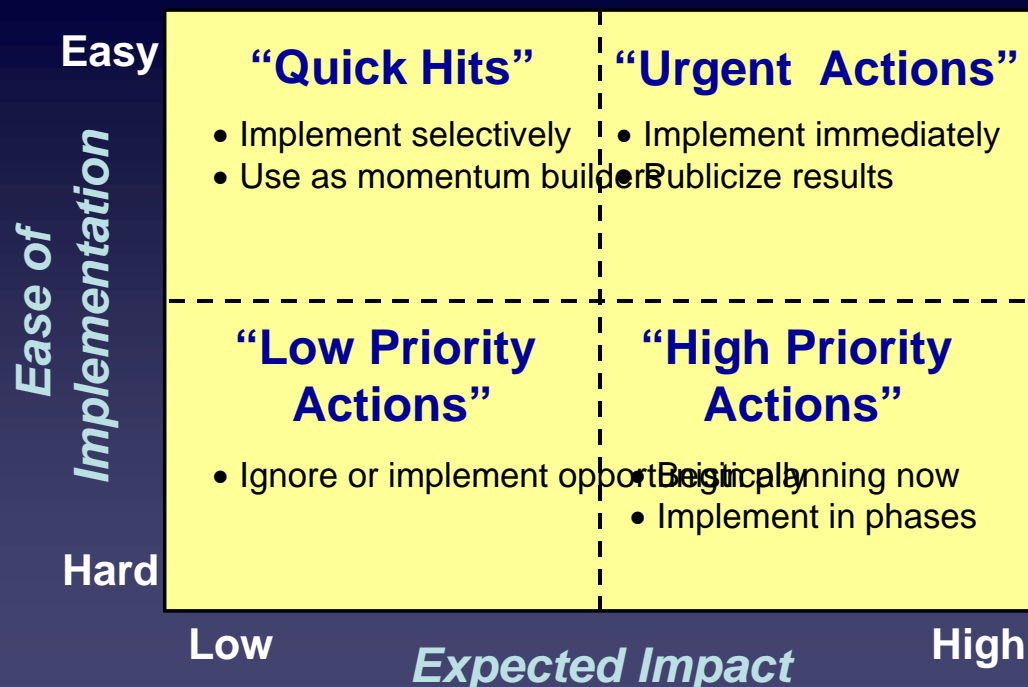
Recommend interventions, w/associated implementation action plan

- 1. What interventions are needed to help meet the objectives?*
- 2. Which of these can USAID most successfully implement?*

Selecting the Best Potential Interventions

Screening Criteria and Prioritization Matrix

- Does the intervention address a real need? Does it fit with USAID's objectives?
- Does USAID have comparative advantage v. other donors? Will the Gov't 'buy in'?
- *Is it likely to achieve impact that outweighs its cost and difficulty?*



Ease of Implementation:

- Cost
- Complexity
- Risk
- Time required

Expected Impact:

- Income
- Coverage
- Sustainability
- Economic Growth

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Applying the Lessons Learned (cont'd)

“Generic” Approach to Designing Interventions in Pension Reform

Stage 1: Framework

- Design appropriate LT strategy for new systems: policy objectives? multi-pillar? coverage targets? level of income protection?
- Identify reforms for existing systems: parametric changes to existing systems or new system needed? managing transition costs?

Stage 2:

Implementation and Beyond

- Regulation/ supervision
- Operational reforms for existing systems, plan administration
- Financial management and IAS
- Public education and advocacy
- Corporate governance
- IT and MIS systems

Capacity Building: Skills Development and Training

Consensus Building: Public Relations

Applying the Lessons Learned

Potential Next Steps for USAID

- Replicate the India project design and approach in other countries where pension reform might be a concern – OEG can create a template and share experiences across Missions
 - The initial assessment is low cost and can be completed quickly
 - Undertaking the assessment provides some “insurance” that subsequent interventions will be sequenced appropriately, targeted, efficient and, ultimately, more successful.
- Consider using similar assessment methodologies for other sectors, e.g. SME and microfinance, capital markets, or banking reform.


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Outcome and Lessons Learned

Ensuring the Best “Bang for the Buck”

- We provided USAID with a prioritized, detailed “menu” of five potential interventions, with initial Action Plans for each.
- Intervention packages spanned a broad range of areas, objectives and skill requirements as well as cost levels.
- “Quick hits” were combined with “Urgent Actions” and longer-term initiatives to combine rapid results with lasting impact.



Clearly identify problems and probability of success before developing solutions, thereby ensuring interventions are appropriate and resources are not wasted.



Accounting, Disclosure, Corporate Governance: Financial Sector Accountability

**United States Agency for International Development
Financial Sector Annual Review and Strategy Forum**

December 11, 2002

Illustrative Country Projects



- ❑ **Montenegro Economic Reform, USAID**
- ❑ **Kosovo Economic Framework (UNMIK), USAID**
- ❑ **Georgia / Latvia / Ukraine / Uganda Capital Markets, USAID**
- ❑ **Bosnia / Bulgaria Bank Supervision, USAID**
- ❑ **Macedonia Accounting and Tax Reform, USAID**

Central Financial Sector Issues - Challenges



- ❑ Legal Framework Exists Generally – Not Accountability
- ❑ No Corporate Governance Culture
- ❑ Local Custom & Practice is Reform Resistant
- ❑ Poor or Non-Existent Enforcement
- ❑ Absence of Demand-Driven Reform

Developmental Context



- ❑ **Corporate Governance Is a Western Concept**
- ❑ **Longer Term Development Horizon to Realize Benefits**
- ❑ **Standardized Diagnostic Approach**
- ❑ **Target Framework Gaps, Inefficiencies & Conflicts**
- ❑ **Support Key Stakeholders To Drive Demand For Change**
- ❑ **Targeted Capacity Building & Training**

- **Use “Bright-Line” Concepts, Approaches & Strategies**
- **Good Governance Starts At The Top**
- **Anti-Corruption Efforts Are Not Optional**
- **Perceptions Matter – Enforcement**
- **Effectively Empower & Educate Stakeholders**
- **Sustainable Reform – Buy-in & Capacity Building**

Lessons Learned - Accounting



- ❑ **Modern accounting standards with their requirements for financial disclosure and transparency underpin financial sector accountability**
- ❑ **National accounting standards – in compliance with ISFR – for both banks and enterprises**
- ❑ **Reform-minded professional association of accountants**
- ❑ **Revised professional training/certification programs for accounting profession**
- ❑ **Revised undergraduate and secondary accounting education programs**
- ❑ **Training programs for government, central bank, commercial bank, and enterprise personnel**

Impact – Future Suggestions



- ❑ **Inter-Disciplinary Program Design & Implementation**
- ❑ **Build on World Bank ROSC Diagnostic Approach**
- ❑ **Develop Best Practice Codes (Beyond OECD Principles)**
- ❑ **Legal / Regulatory / Judicial Reform Focus**
- ❑ **Training & Certification Programs**
- ❑ **Tax Reform / Simplification (Watch Russian Experience)**

Financial Sector Annual Review and Strategy Forum

**Accounting Reform - The Russian
Case-Study: SEGIR-FS Technical
Assistance to the Inter-Agency
Coordination Committee - Accounting
and Reporting Working Group**



SETTING THE STAGE

- August 1998 financial crisis causes loss of confidence in the banking sector.
- In response, the Central Bank of Russia (CBR) establishes the Inter-Agency Coordinating Committee (IACC):
 - IACC Members are CBR, MinFin, ARCO, commercial banks and donors (including IMF, World Bank, USAID, EU/Tacis).
 - IACC is divided into working groups - bank restructuring, supervision, legal, accounting, operations and training.
- USAID technical assistance support agreed in 1999.
- DAI project commences March 1, 2000.
- In the third quarter 2000, CBR starts a similar TA project with EU/Tacis (PricewaterhouseCoopers as contractor).



CENTRAL FINANCIAL SECTOR ISSUES

- Restore the internal and external confidence in the Russian banking sector and contribute to its medium term stability;
- Improve existing bank transparency through changes in accounting and reporting regulations based on International Accounting Standards (IAS);
- Develop new regulations to support proper implementation and use of IAS by commercial banks;
- Improve quality of reporting to the Central Bank to enhance bank supervision;
- Train personnel of Central Bank, Commercial Banks, and Accounting Firms in IAS

RUSSIA PROJECT STRATEGY

TASK A - Provide support to the Reporting Committee, the Technical Accounting and the Training Committees of the IACC on Accounting Reform.

TASK B - Organize and conduct accounting pilot projects in selected commercial banks.



PROJECT OUTPUTS

TASK A

- Analyzed over 4,000 pages of documents to understand differences in Russia Accounting Standards, Tax Code, Civil Law, MinFin regulations and IAS.
- Became a resident advisor to the CBR to respond to many accounting issues, provide comments on proposed changes to regulations and assist in the preparation of new instructions.
- Revised implementation strategy to transformation of RAS data to IAS compliant financial statements (after CBR changed implementation date to January 1, 2004).
- Coordinated with EU/Tacis and other projects/donors on new accounting guidelines and instructions.

PROJECT OUTPUTS - continued

Coordination with others:

- Donors and institutions:
 - World Bank, IMF, ARCO, Ministry of Economy, Ministry of Finance, British KnowHow Fund (DfID) and Canadian Government TA programs.
- Coordination with other projects:
 - EU/Tacis - PricewaterhouseCoopers – CBR, EU/Tacis - KMPG - Min Fin, FIDP, ICAR, FIAR, and FSVC.



PROJECT OUTPUTS - continued

- Assisted in the presentation of the first CBR consolidated financial statements compliant with IAS (to satisfy World Bank and IMF requests).
- Implemented the IAS unit at CBR.
- Provided IAS training to 67 CBR staff in the Accounting, Supervision and General Economic departments.
- Provided Training of Trainers - the new trainers then trained over 400 supervision personnel in IAS.
- Provided IAS training to 40 participants at ARCO.
- Provided IAS Training in Samara, Novosibirsk, Omsk and Vladivostok (through FSVC) to 225 participants including chief accountants of CBR regional offices and commercial bank personnel.

PROJECT OUPUTS - continued

TASK B

- Two commercial bank pilot projects were completed by May 2001 (Moscow and Nizhny Novgorod) and the third bank in July 2001 (Rostov-on-Don).

At each bank, the project reviewed:

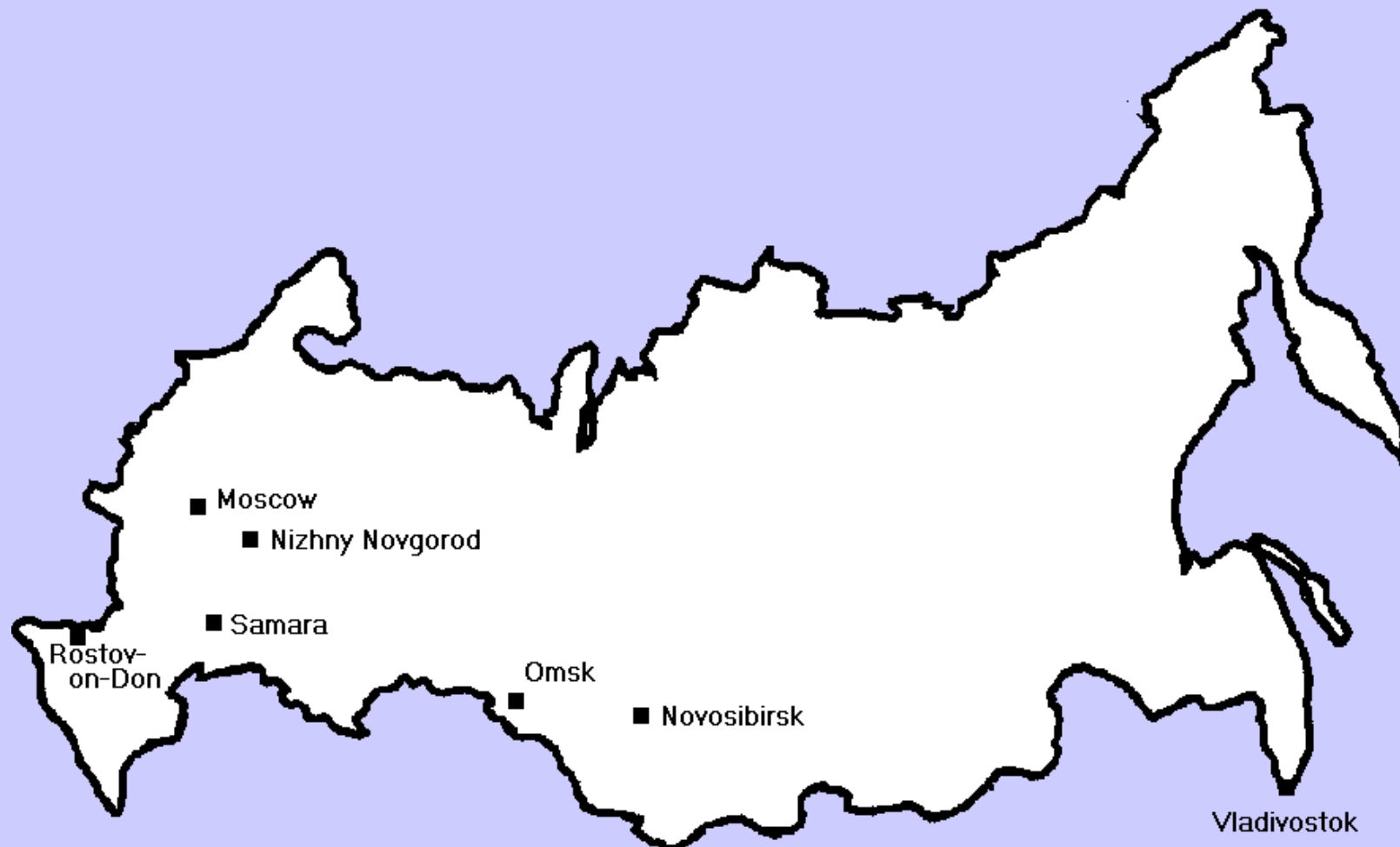
- Accounting methodology and systems to determine ability of banks to generate IAS compliant financial statements;
 - Internal controls and policies and procedures;
 - Existing management reporting for use in decision making; and
 - Methodology for transforming financial statements from RAS to IAS.
- From the review, case studies were created to use in other commercial banks.

The project also provided:

- An IAS workshop at each pilot bank (45 participants); and
- IAS lectures to 128 participants at three locations.



LOCATION OF TRAINING - IAS WORKSHOPS



TANGIBLE RESULTS

- Adoption of transition timeline nearly one year after its initial presentation.
- Agreement and public announcement for commercial banks to report to CBR using IAS compliant financial statements by January 1, 2004.
- Formation of IAS unit at CBR.
- Adoption of guidelines& formats for IAS compliant Cash Flow Statement Preparation.
- Revision of other instructions and guidelines revised for commercial bank reporting in accordance with IAS (completed under the EU/Tacis project).
- Creation of institutional capability within the pilot banks to prepare monthly IAS compliant financial statements without assistance of external auditors.
- Training at 12 workshops and other presentations included more than 500 participants and new trainers trained 400 CBR supervision personnel.
- Created a better understanding and acceptance of IAS concepts and application by a broader base of personnel at CBR and commercial banks.

LESSONS LEARNED AND FUTURE APPLICABILITY

Based on experience in Russia and five other countries:

- Immediately push for laws on current and future IAS compliant accounting.
- Translate Terms of Reference to be immediately shared with counterparts.
- Allow counterparts to comment on the work plan and share the final version.
- Consider funding salaries of IAS specialists for the Central Bank - qualified specialists are usually attracted to higher-paying private firms.
- Consider TA to universities to add IAS to curriculum.
- Provide significant training funds for current IAS and future IAS updates.
 - Thousands of personnel in accounting and supervision at the CBR, 10,000 accounting specialists at commercial banks, Hundreds working in external audit firms.

LESSONS LEARNED AND FUTURE APPLICABILITY

- Concentrate on long term accounting advisors. Short-term accounting advisors have limited success.
- Ensure initial buy-in from the Central Bank with written support.
- Conduct training in corporate governance for senior managers, line managers, and internal auditors within the commercial banks.
- Include international and local accounting firms and tax inspection personnel in the training process and technical assistance being given.
 - In Armenia, 8 of 9 financial statements purported to be in compliance with IAS were incorrect.
 - In Montenegro, the local office of a large international CPA firm gave incorrect advice on accrual of income tax liabilities.
 - Many countries are developing specialists within the tax inspectorates who will be responsible for tax audits and examinations for commercial banks.

LESSONS LEARNED AND FUTURE APPLICABILITY

- Focus on local accounting and consulting firms to provide IAS expertise. Otherwise, larger, international accounting firms will control the work at a higher cost.

Other Donors' FS Technical Assistance Activities

Gillian G. H. Garcia

USAID Financial Sector Review and
Strategy Forum

December 12, 2002

Roadmap

I. Introduction

II. Surveillance

III. Technical assistance

IV. Conclusions

I. Introduction

Mandate

Criteria

The Players

Data Problems

Data Sources

Mandate for the Paper

- From the Task Order:

“Assess who does what in terms of strengthening, safeguarding, standardizing, and regulating reform of the international financial system as it affects the financial system of developing countries”

Review of Domestic and International Players in Financial Sector Development*

Examines who does what in:

Reforming the International Financial Architecture

Surveillance

Financial Assistance

Technical Assistance

*Completed in March 2002

Criteria for Choosing the Players

- Importance of the surveyed player's activities for strengthening the financial system and reducing poverty
- Relevance of these activities for USAID's future work in the financial sector.

Of the 26 Players Surveyed

International Organizations	IMF, WB IBRD, IDA, IFC, MIGA, BIS, FSF, FSI, OECD, Paris Club, WTO
Regional Development Banks	AfDB, ADB, EBRD, IDB
Bilateral Donors	EU, France, Germany, Japan, U.K., US
Private Sector	Group of Thirty, IIF, ICRC, Oxfam, S&P
4 sectors	18 are relevant today

Data Problems

- No central data base for financial or technical assistance to financial systems
- OECD attempts to collect data on financial and technical assistance to developing countries
- But its data on aid to the financial sector is scattered over several categories
- The Review team had limited resources with which to supplement these data sources

Data Sources and Consequences

Annual Reports

- Web sites
- Answers to e-mailed requests
 - Telephone discussions
- Consequently, the results must be seen as impressionistic rather than definitive

II. Surveillance Subjects

- Types of surveillance activities
 - Surveillance players
 - FSAPs and ROSCs
- The effectiveness of FSAPs and ROSCs
 - Need for TA as revealed by FSAPs
 - Opportunity for USAID and other bilaterals

Surveillance Encompasses:

- Macroeconomic policies and conditions
 - Data collection and dissemination
 - Developing standards and codes
- Monitoring standards and codes, and
 - Features FSAPs and ROSCs

Players Active in Surveillance

Body	Data	Inspect	Develop St&Cd	Monitor S&C
IMF	H	H	H	H
WB	H	H	H	H
BIS	H	L	H	
FSF	L			
OECD	H	H	H	
RDBank s	L	L		
EU	L	L	L	
Bilateral s			L	
Group 30	L	L	L	
S&P	H	H	L	

New Surveillance Vehicles

- Financial Sector Assessments
(FSAPs)
- Reviews of Standards and Codes
(ROSCs)

ROSC 12 Standards and Codes

Topic	Code Set by:	Monitored by:
Data	IMF in SDDS, GDDS	IMF
Fiscal	IMF	IMF
Monetary	IMF	IMF
Bank Supervision	Basel Core Principles	IMF
Securities	IOSCO Principles	WB & IMF
Insurance	IAIS Principles	IMF & WB
Payments	BIS/CPSS's Principles	WB & IMF
Money Laundering	FATF Recommendations	IMF & WB
Corporate Governance	OECD Principles	WB
Accounting	IAS Standards	WB
Auditing	IFAC Statements	WB
Insolvency	UNCITRAL, INSOL, WB, IMF	WB

FSAP/ROSC Effectiveness

- Early “teething problems” being resolved
 - Heavy demands on Bank & Fund staff
- (IMF supplements only from central banks and supervisory agencies (i.e., no private sector involvement, Bank is less rigid))
- Showing very great need for pre- and post-FSAP TA
 - That the Bank & Fund cannot provide

Resulting Opportunities

USAID and other bilateral donors can fill
the FS TA gap

But does FSAP secrecy present a problem?

The FIRST Initiative

III. Technical Assistance

- Donor resources available
- Types of assistance offered
- Is there a need for a data base on FS activities?
 - And coordination of donor activities?

Impressions Formed of FS TA

- Many players offer similar types of assistance,
- Often as loans not grants,
- In the same or similar countries; while the
- Importance of FS TA is often under-appreciated;
- (Rather donor publications stress building roads, bridges, dams, and ports, and improving agriculture, industry, and social services).
- So little is known about FS TA and its efficacy is
- Rarely evaluated.

TA by Donor in 2000-2001

Donor	Total TA	% FS	Grants or Loans
IMF	118	~ 100%	All grants
WB	945	~20%	Mainly loans, some grants
BIS	114	~ 95%	No charge
OECD	200	...	Grants
4 RD Banks	1,000	6%-50%	More loans than grants
EU	2,500	5%	Grants
France	1,300	10%	Loans and grants
Germany	1,650	6%	All grants
Japan	2,430	1%	Both
UK	685	5%	Mostly grants
USAID	2,550	2.5%	All grants
World Total	12,767-OECD	1% - 50%	Both loans and grants

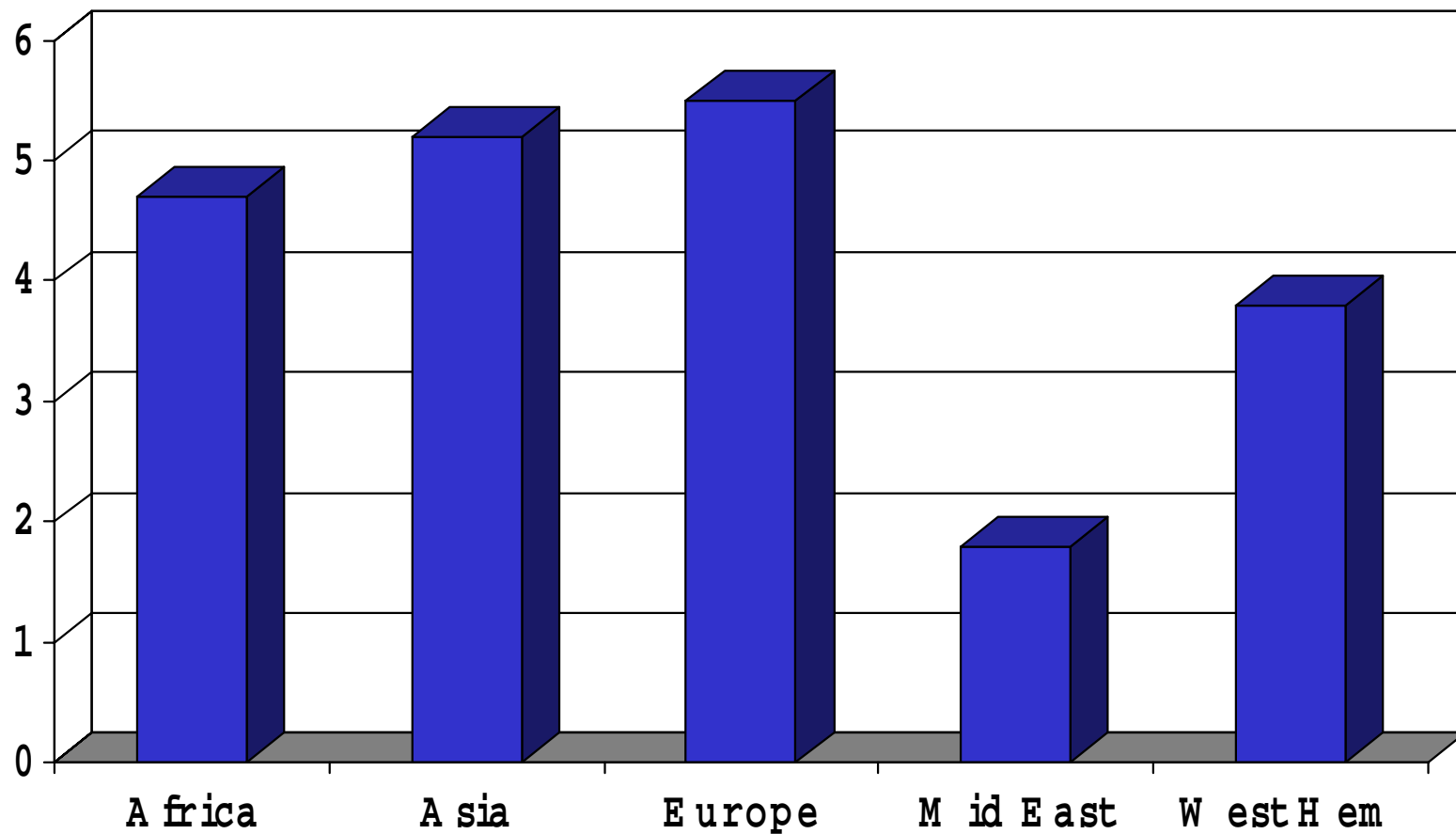
Who Does What in FS TA?

Donor	Paym	Banks	CapM	Insu	Pensn	Hous	SM E	NBFI	CorpG	MonL	Acc
IMF	H	H	H		L		L	L	H	H	L
WB	H	H	H	H	H	H	H	H	H	H	H
BIS	H	H	H	H				L	H	H	L
OECD	L	H	H	H	H	L	L	L	H	H	H
4RDB	L	H	H	H	L	L	H	H	H	L	L
EU	H	H	L				H		L		H
France		H					H	L			
Germany	H	H	H			H	H	H			
Japan	H										
UK		L	H	H	H		H	H	H	H	H
USAID	L	H	H	H	L	H	H	H	H	H	H

Filling Gaps or Competing?

- When USAID sees where other donors are putting their resources, does try to fill the gaps or cover all bases?
- Clearly there are gaps in insurance, pensions, housing finance, countering money laundering, accounting/auditing, rating agencies, data on, and evaluations of, FS TA.
- But greater crowding in banking, securities/capital markets, SMEs, and non-bank financial institutions.

Average Number of TA Donors per Country by Region



Country Implications for USAID

- Some countries receive TA from a large number of donors (e.g, Russia)
- Others are neglected; e.g.in the Middle East
- Bilateral donors chose countries for historical, foreign policy, and/or commercial reasons
- But the review team recommends using an effectiveness topology

IV. Conclusions

Implications for USAID

- AID a significant provider of both total & FS TA
- It needs more FS resources than its current 2.5%
- Its all-grant policy is attractive to recipients
- It can help fill gaps that FSAPs reveal on its own
- Or cooperate with other donors (FIRST initiative)
- It can keep its own and a world FS TA data base
- Do more, and systematic, evaluations, and



Finance for Growth

- Governments need to do
 - More and better in some areas
 - Less in others
- And to recognize how finance without frontiers is changing what they can do, and can achieve
- Because finance matters for growth and poverty reduction, and we have the evidence



Main messages

- Well functioning markets need:
 - legal and regulatory underpinning
 - strategy based on harnessing incentives
- Diversity is good for stability and development
- Good safety nets require good institutions
- Governments are not good at providing financial services, even when a crisis hits
- Open markets, technology can spur development–



What it does not say

- Not to 'leave finance to the market.'
- Not to privatize banks all at once
- Not just open up to entry to foreign financial firms and leave it to them.
- Not just open to capital flows without robust regulatory system.



What government needs to do

- Finance is about changing money today for money tomorrow
 - ⇒ if information or contract enforcement is lacking, no credit is the result
- Finance boosts growth by
 - Widening access to external finance (more firms, more sectors)
 - Raising productivity
 - not the scale — of investment

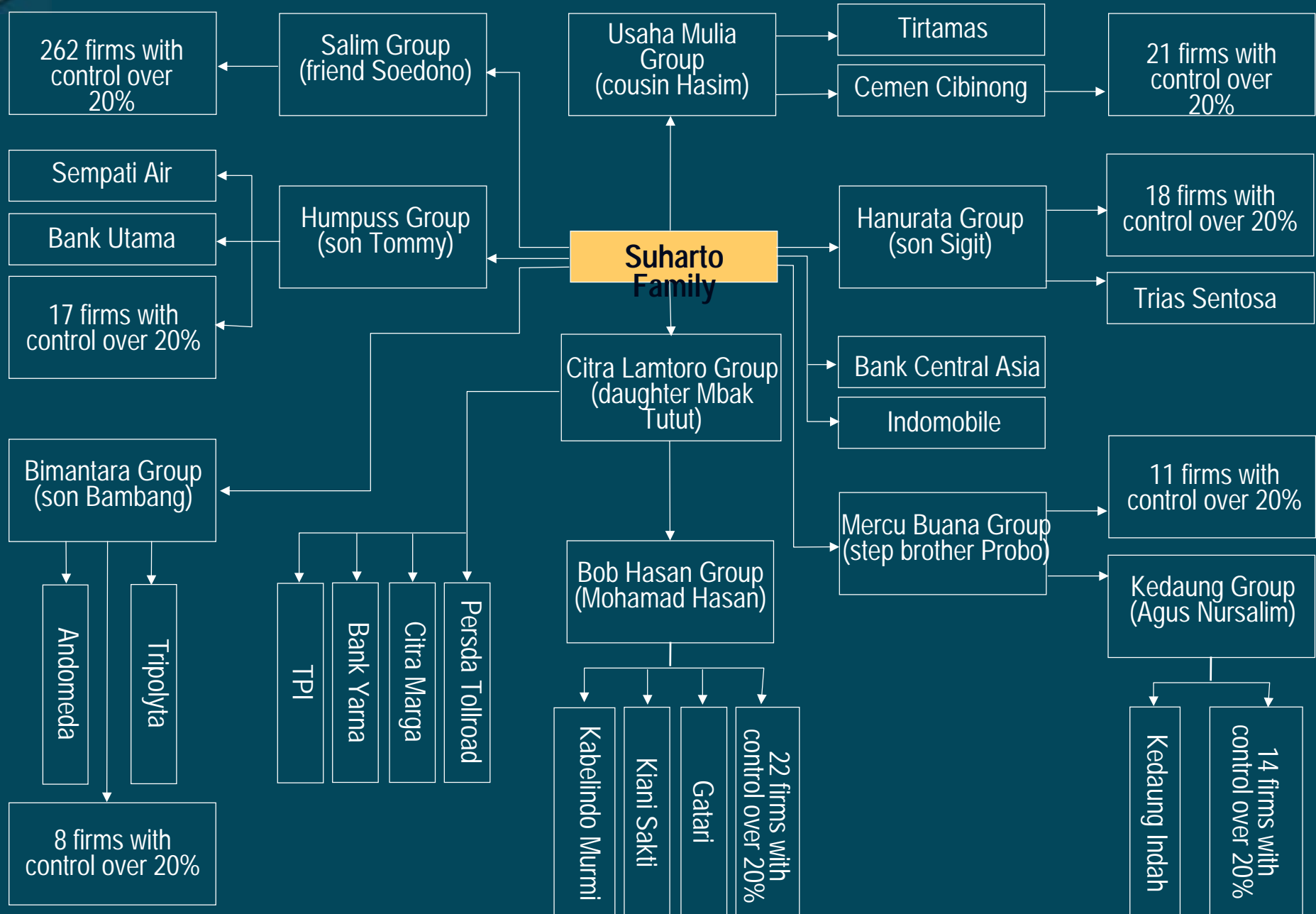


But beware!

- Bigger is not necessarily better
- Focus on effectiveness – not size
- Beware of:
 - too rapid credit growth...
 - forcing the pace with state-owned banks
 - tilting the system to one particular type of structure not advised – both bank and market based systems have worked.
 - recognize that most governments implicitly or explicitly subsidize banking



“And the owner is... the Suharto family group”





What to do

- Better to build a solid infrastructure
 - ...than to aim for a particular structure
- Improving the information infrastructure and technology can lower intermediation costs –
 - outweigh potential drawbacks (lost privacy and credit discrimination)
- The better the infrastructure, the greater the *sustainable* reach of the sector.



Towards better banking

- FFG focused attention on the role of incentives for all the actors – owners, markets, and supervisors
- Too often, we note but then give up on key incentive issues, such as:
 - Skewed balance of terror for supervisors
 - Adoption of deposit insurance before regulatory framework in place; subsidization skews financial system.
- Generally, markets better at oversight than acknowledged \Rightarrow give them more support.



Bureaucrats as bankers: the evidence

Greater state ownership leads to:

- less financial sector development, lower growth, lower productivity
- higher interest rate spreads, less private credit, less nonbank financial development
- greater concentration of credit
- some tendency towards more crises, weaker monitoring



Evidence that State Banks can be reformed



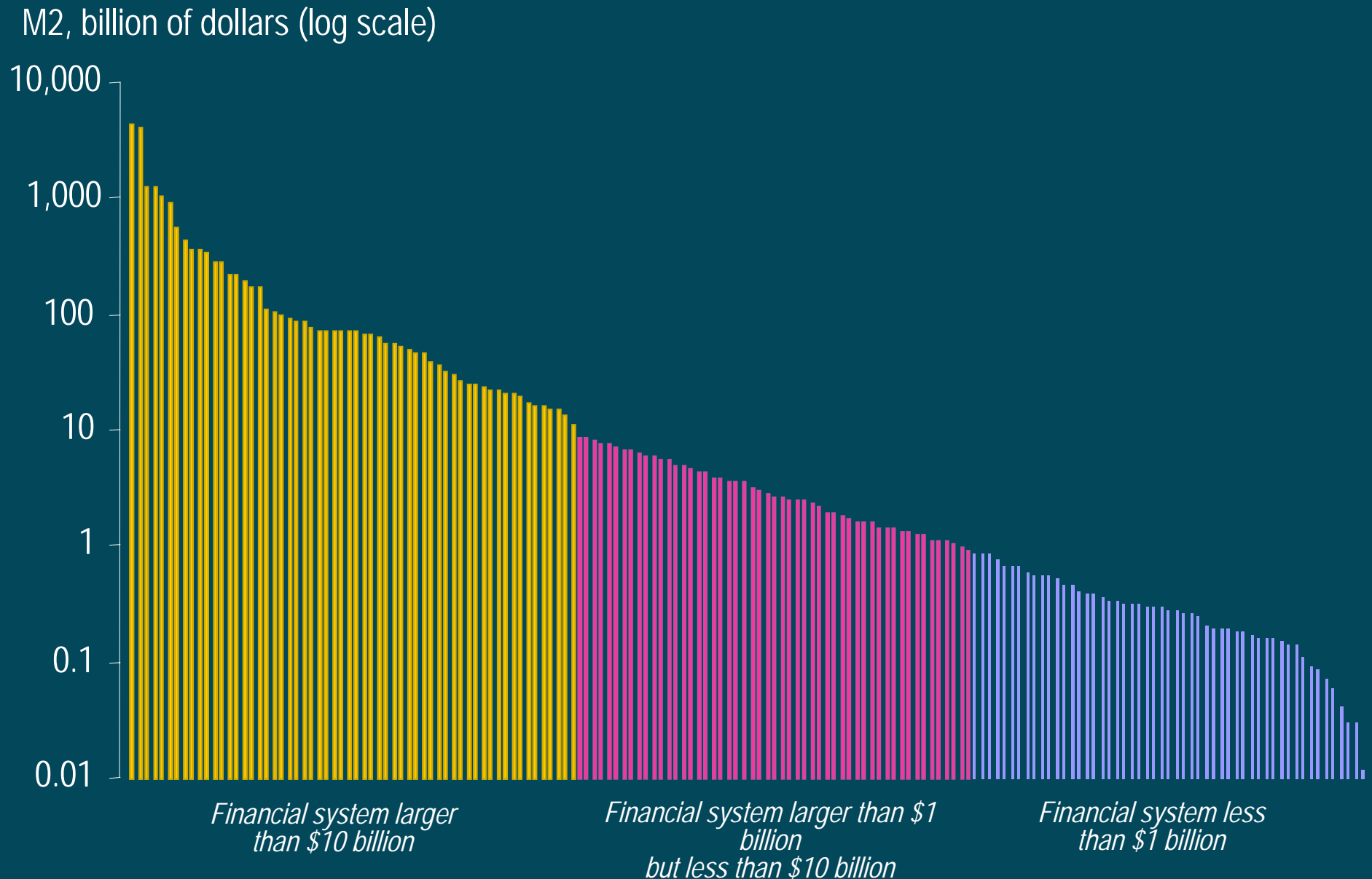


Finance without frontiers

- What services to buy, and what to build at home
 - What matters for growth is access to financial services, not who supplies them
- Most emerging markets are too small to afford a closed financial system with exclusively ‘domestic’ banks and other intermediaries



National financial systems ranked by size



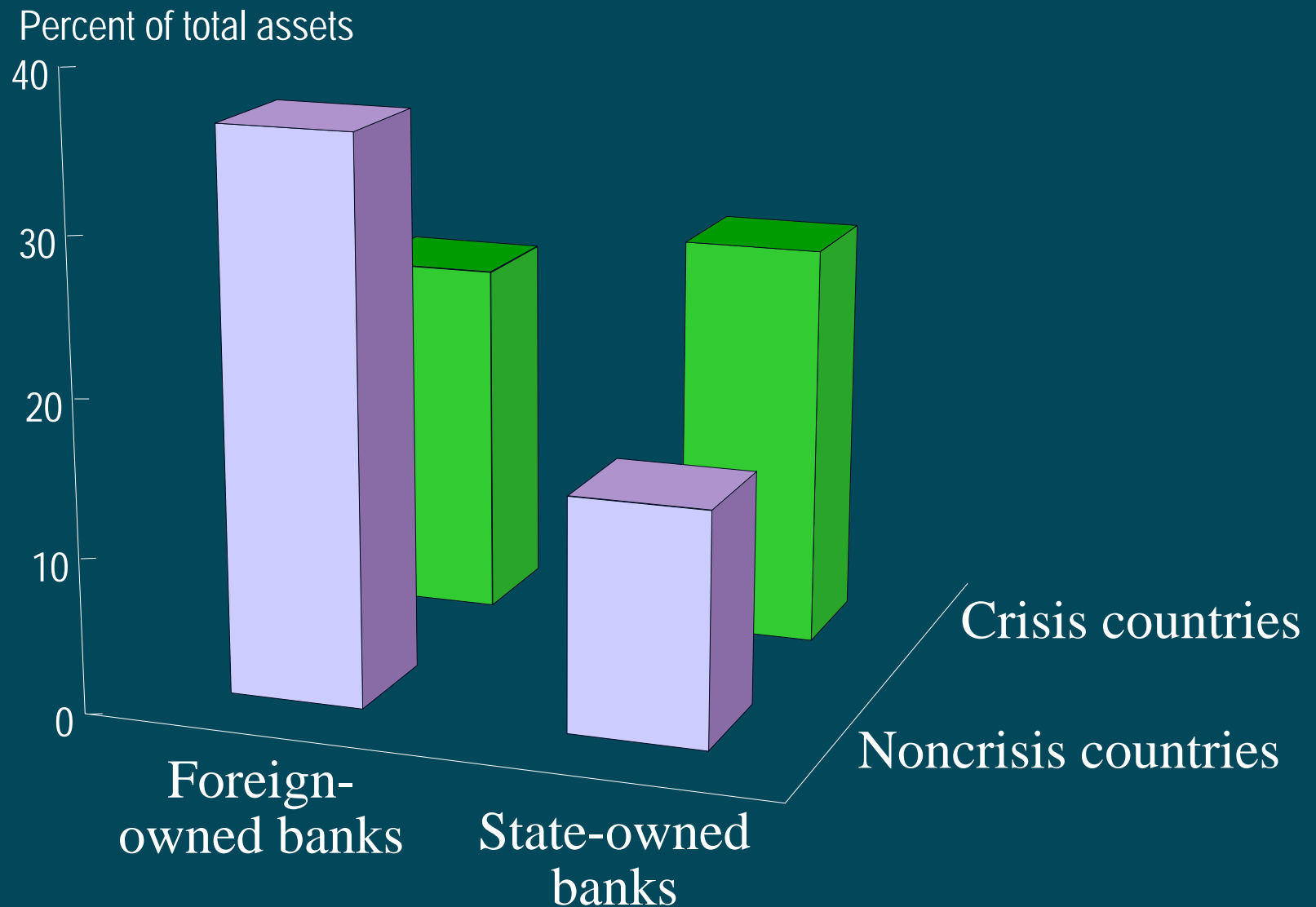


Financial services: foreign provision

- Emerging markets can benefit from importing financial services
- Despite worries that foreign firms could destabilize domestic finance –
 - there is little evidence to support such fears... in fact, it goes in the other direction!



Comparing the share of foreign and state ownership in crisis and noncrisis countries





Implementing Finance for Growth

- Return to basics: help improve information environment and contract enforcement
 - If a large percentage of our efforts are not spent on infrastructure, we are missing the point
- Start and end with incentives: don't drop the ball even when it is hard (e.g. supervisors)
- Build consensus for sensible financial sector reforms
 - Entails more reaching out beyond finance ministeries and central banks to civil society.



Financial Sector Led Growth Initiative



The Message of the Financial Sector Led Growth Initiative

- Financial sector openness offers two fundamental benefits:

» *Growth*

» *Stability*



Empirical Evidence for Financial Sector Led Growth

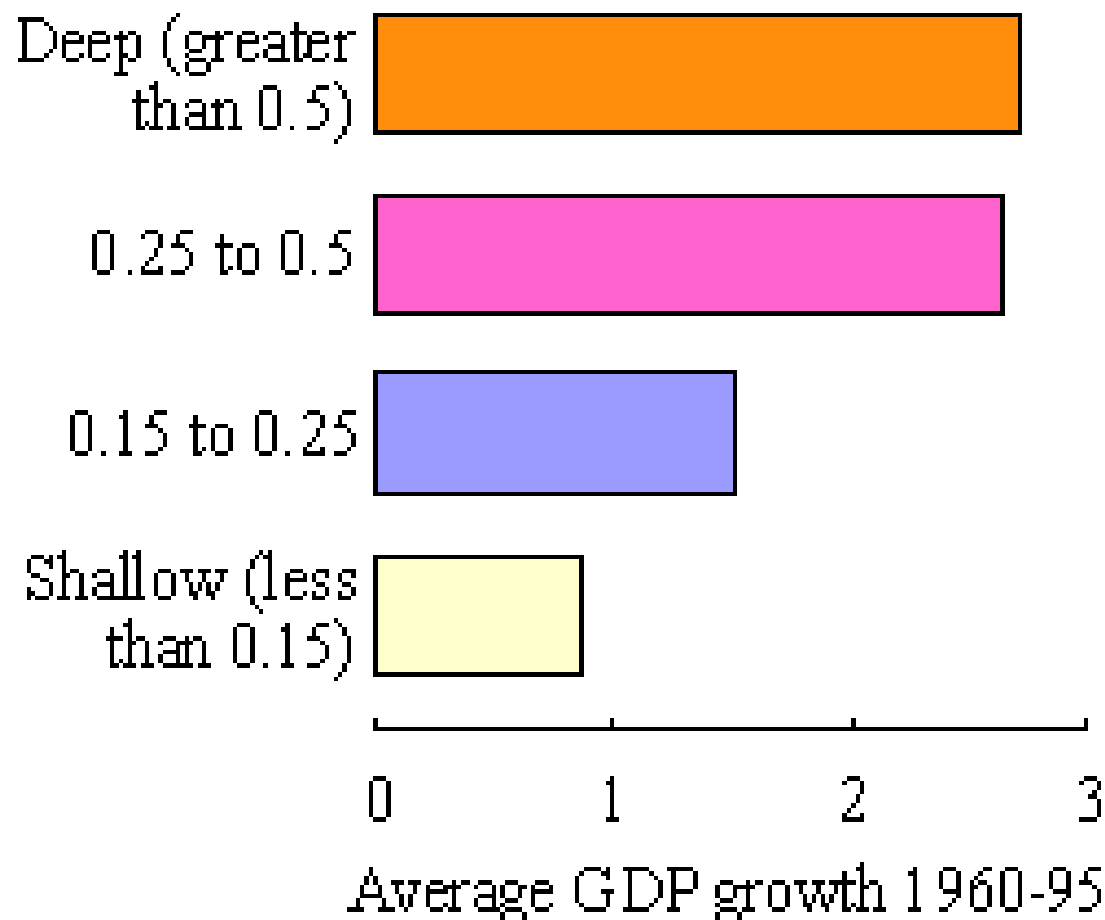
Studies show that liberalizing and deepening the financial services sector, in conjunction with strong legal, supervisory and regulatory institutions, is associated with higher rates of growth, particularly in developing countries:

- Countries who liberalize the financial services and telecommunications sector were shown to increase growth 1.5 percentage points faster than others. This rate is 2.5 percentage points when looking at developing countries alone. (Matoo et al., “Measuring Services Trade Liberalization and Its Impact on Economic Growth: An Illustration”, World Bank/IMF, August 2001)
- Doubling the ratio of private credit to GDP is associated with an average long-term growth rate almost 2 percentage points higher. (World Bank, *Finance for Growth*, 2001)



Financial Depth Generates Subsequent Growth

Ratio of liquid liabilities
to GDP, 1960



Source: World Bank, *Finance for Growth*, 2001.



How does financial sector development increase growth?

A liberalized and competitive financial sector can promote growth of output and income by:

- Channeling investment to their most productive uses
- Enhancing capital accumulation
- Increasing the productivity of investment, not just increasing investment
- Minimizing transactions costs through trading of risk, monitoring managers, and mobilizing savings



Benefits Beyond Growth

- Widens access to external finance and expands local markets (more sectors, more services). Access to financial services is more important than who provides them
- Increases stability through diversification of risk.
- Promotes efficiency and transparency
- Strong supervisory and regulatory systems ensures constructive incentives for financial market participants
- Introduces technical expertise, capital for new investment and identification of development opportunities
- Introduces of best practices for risk management, credit analysis, maturity management and training for local management and staff



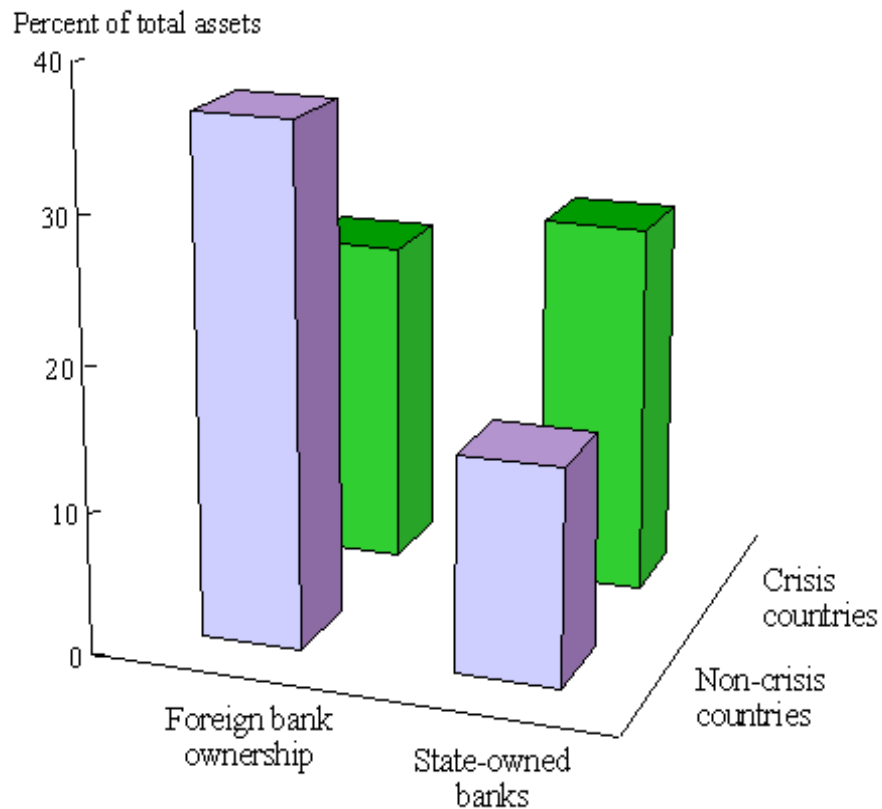
Empirical Evidence for Financial Sector Led Stability

Studies also show that liberalizing and deepening the financial services sector, in conjunction with strong legal, supervisory and regulatory institutions, is associated with increased stability in domestic financial sectors:

- “Foreign participation with fair competition in financial services is a key ingredient in building a reliable and durable financial system. This in turn builds confidence, fosters growth , and is therefore crucial for stability.” (Kireyev A., “Liberalization of Trade in Financial Services and Financial Sector Stability”, *IMF Working Paper*, June 2002)



Comparing the share of foreign and state ownership in crisis and noncrisis countries



Source: Barth, Caprio and Levine. 2001.

The level of foreign ownership in a financial sector can contribute to crisis avoidance. Foreign bank entry can strengthen the financial sector and increase stability. In fact, foreign entry has been associated with systemwide improvements in the quality of regulation and disclosure.



What are the steps to liberalization?

- Remove any impediments to an open, transparent financial sector
- Strengthen supervision or reform regulations to create the right incentives for growth oriented sector

What do we mean by liberalization?

- By “liberalization” we mean opening domestic markets to FDI in financial services and according foreign and domestic firms equal treatment. This is distinct from opening the capital account.



Barriers to Realizing Growth

- Limitations to levels of foreign equity participation
- Limitations to the form of establishing commercial presence (branches vs. subsidiaries)
- Lack of access of foreign participants to local financial networks (e.g. ATMs)
- Economic needs test
- Quantitative limits on foreign presence or total number of institutions
- Non-transparent financial regulations
- Undefined/non-public licensing requirements for financial institutions
- Limitations on scope of business (no deposit taking, trading in government securities)
- Client limitations (e.g. only foreign invested firms)
- Requiring local establishment even for advisory/informational service



History of U.S. Liberalization

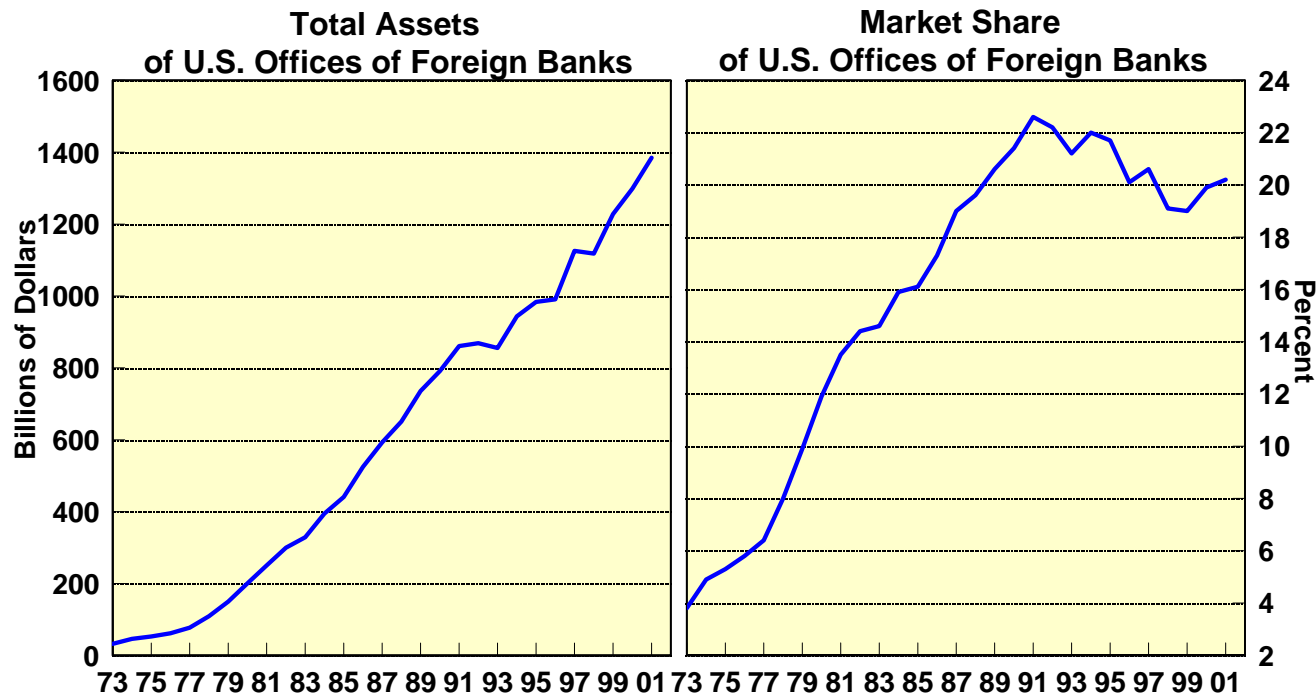
- Promoting innovation in the banking sector
 - recognizing foreign banks*
 - promoting domestic competitiveness
 - resolving banking sector problems
 - improving market incentives and supervision
- Strengthening securities markets
 - improving disclosure and monitoring
 - promoting competition and efficiency

*Foreign banks are those with foreign ownership > 25%.



Foreign Financial Services Providers' Participation

FOREIGN BANK PRESENCE IN U.S. MARKET



Note: U.S. Offices of Foreign Banks include foreign bank branches and agencies, New York investment companies (through Sept. 1996) and U.S. commercial banks of which more than 25 percent is owned by foreign banks, and International Banking Facilities. Market share reflects share of total of domestically-owned plus foreign bank assets.

- Swift and significant penetration.
- Market share stabilized as U.S. banks responded.



Benefits of Greater Foreign Participation in U.S.

- Introduced innovations that allowed US banks to increase international lending (new pricing)
- Competitive pressure improved U.S. banks' domestic performance.
- Increased capitalization of the banking system.
- Provided assistance in resolving problem domestic banks.



Promoting Domestic Competitiveness

- Eliminated interest rate ceilings for consumers and depositors.
- Allowed banks and thrifts to offer new deposit and lending products.
- Allowed interstate banking and affiliations among broad financial services companies.
- Prohibited anticompetitive brokerage commission setting.
- Strengthened audit system.



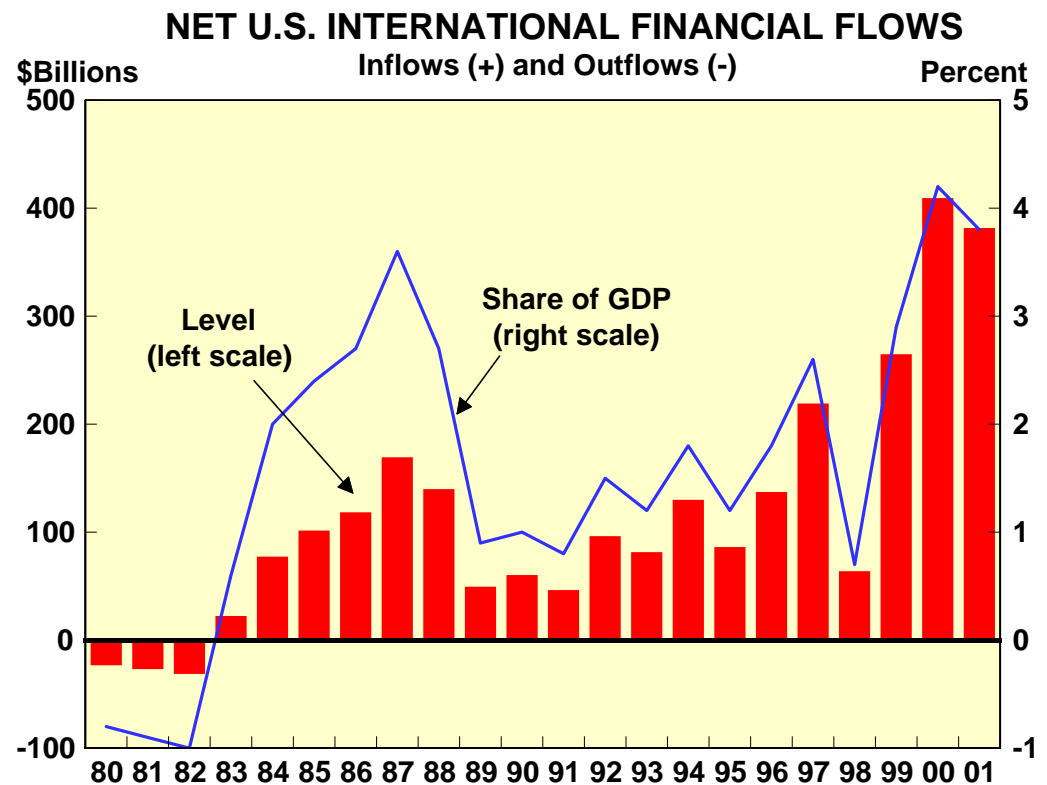
Allocational Efficiency Increased

- Increased productivity in the banking and securities sectors
- Strong banks merged, grew
- Improved business and consumer access to bank credit facilitated faster small and new business growth, more consumer finance options



Investment Environment Became Increasingly Attractive

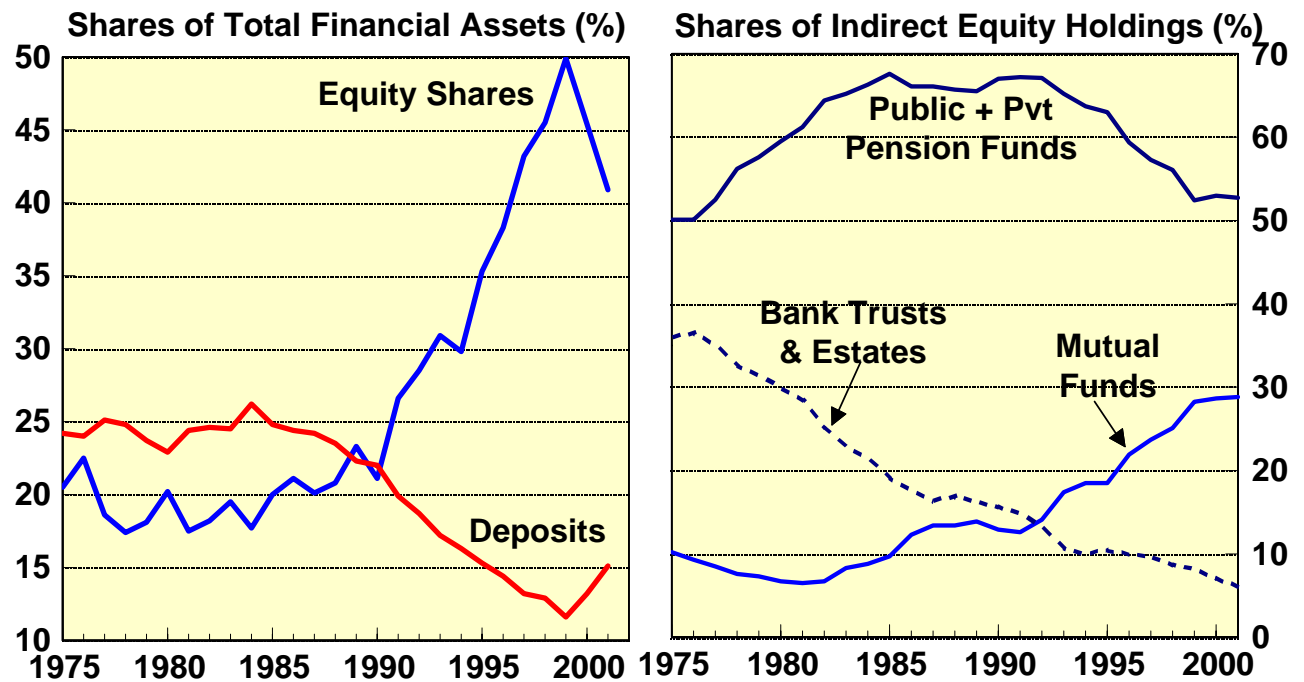
- Liberalization may have increased the volume of funds available for productive investment.





Benefits to Consumer Finance

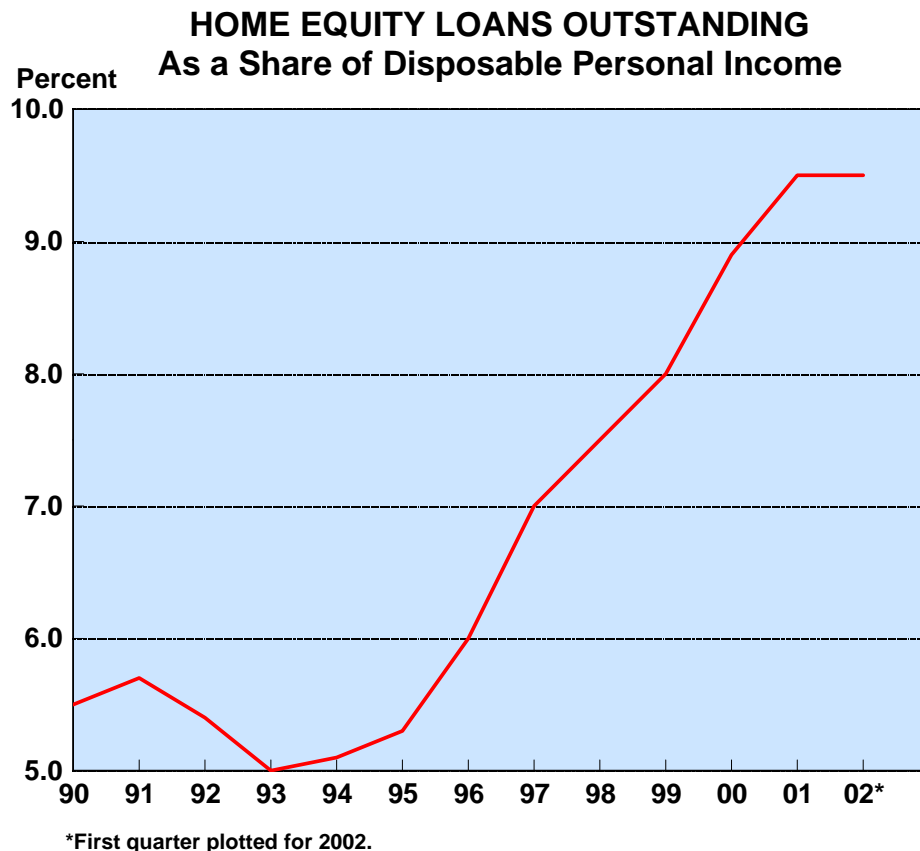
- Declining transactions costs
- Broader range of investment options:
 - money market mutual funds
 - NOW accounts
 - 401(K)s and IRAs
- Transformed household asset allocation



Note: Equity shares include both directly and indirectly held shares. Indirect equity holdings are held through bank trusts and estates, life insurance companies, private pension funds, state and local retirement funds, and mutual funds.



U.S. Experience: Benefits to Consumer Finance

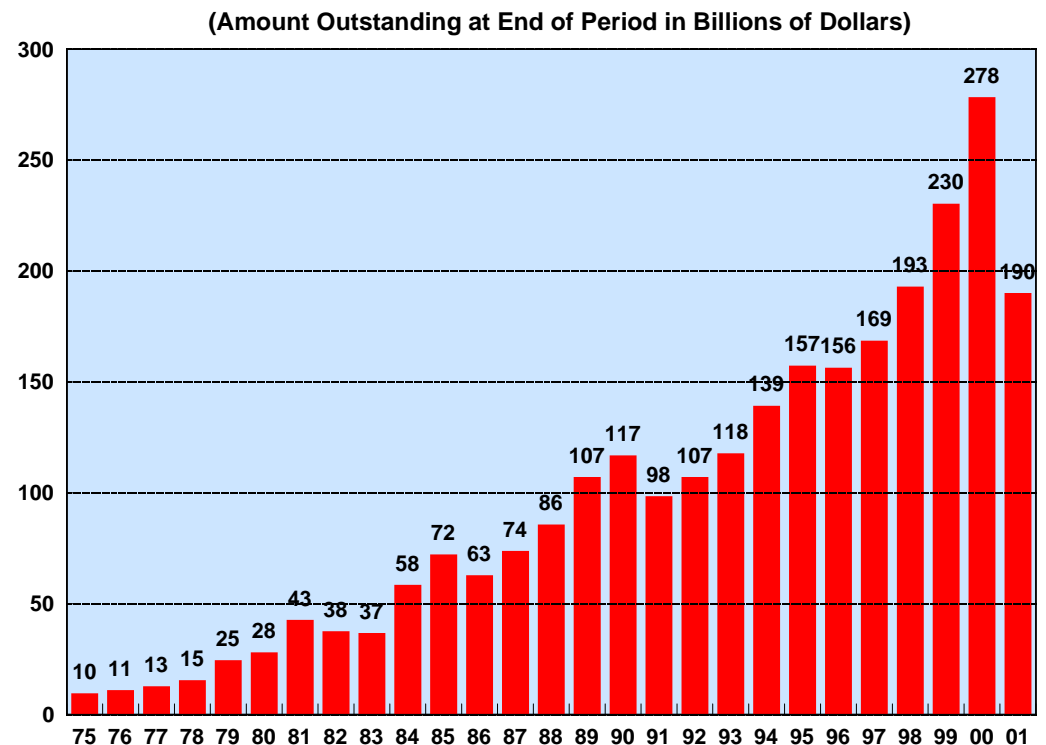


- Increase in credit availability:
 - increased secondary mortgage credit
 - home equity loans
 - credit cards



U.S. Experience: Benefits to Corporate Finance

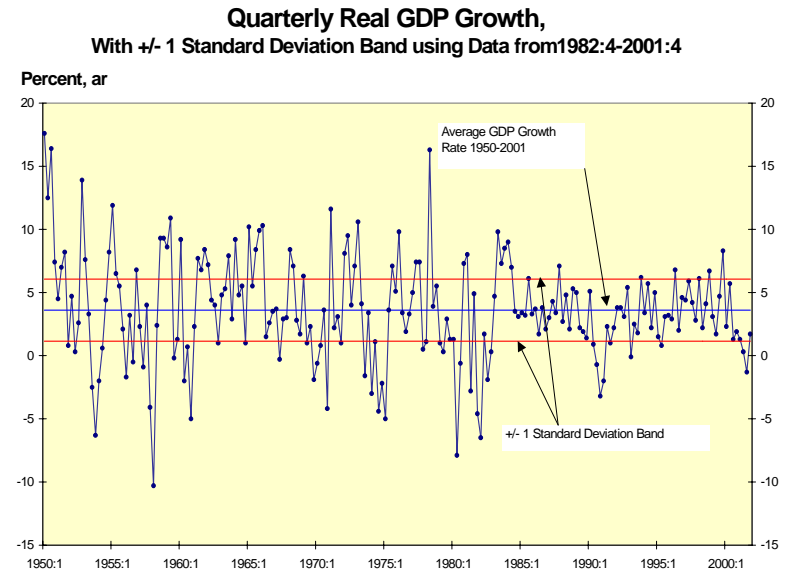
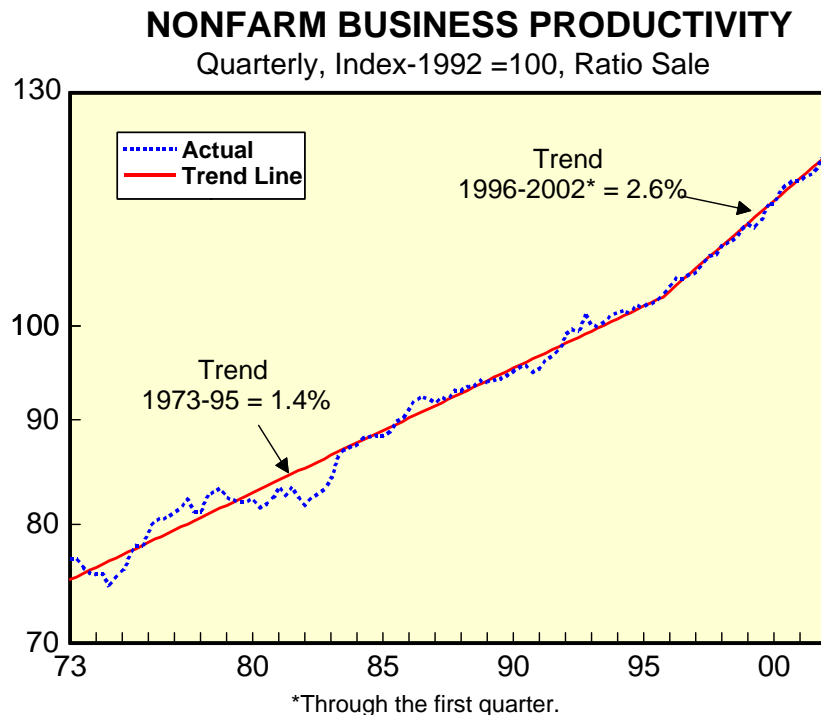
- Wider range of financial instruments available to businesses -- especially small businesses and start-ups.
 - Growth of the commercial paper market
 - Increased market for venture capital
 - NASDAQ made it easier to execute IPOs
 - Rise of the junk bond market
- Enhanced business sector's ability to raise funds for investment.





Macroeconomic Benefits

- Stability increased



- Productivity growth accelerated

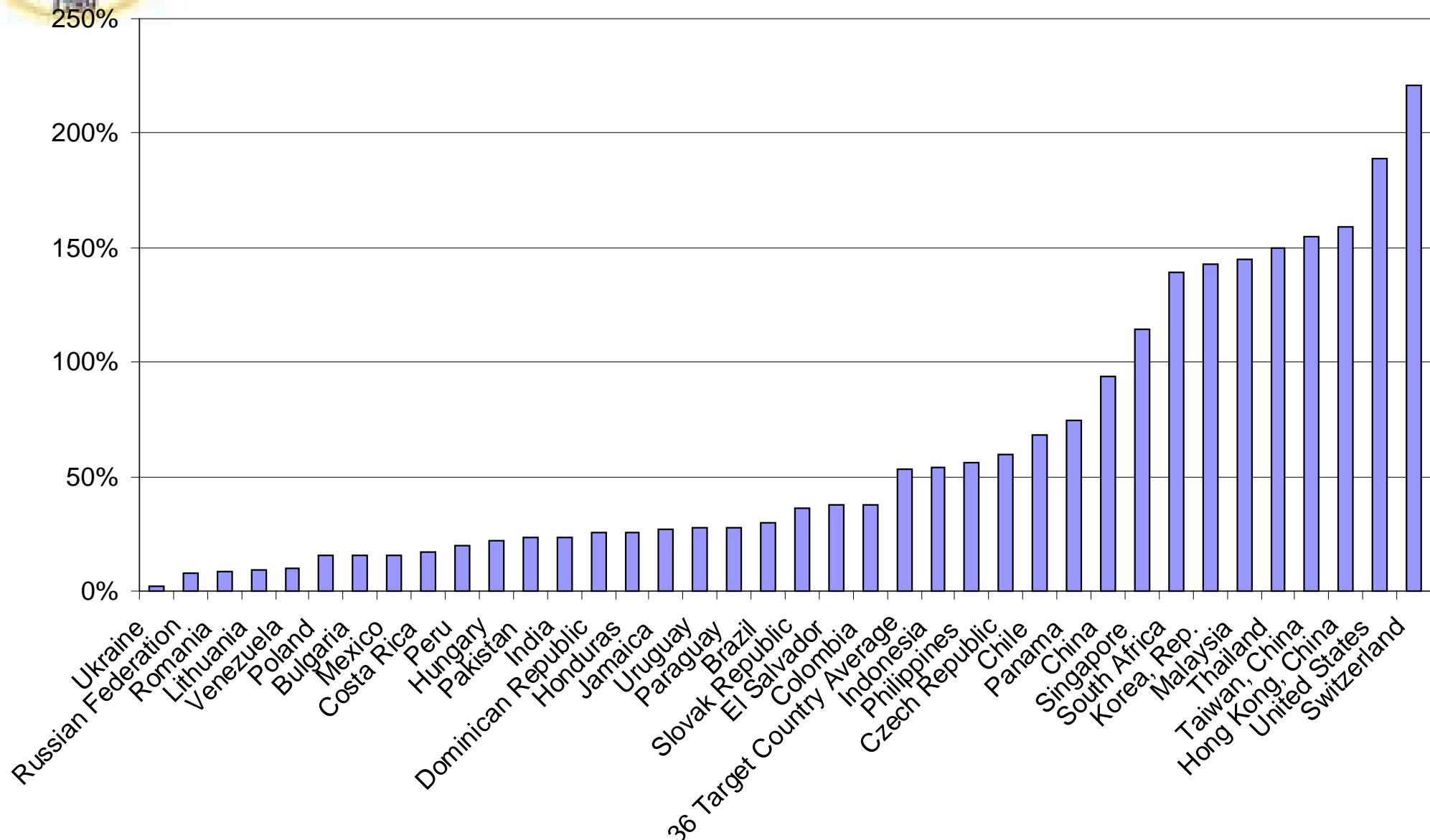


Measuring Success

- Quantitative measures: private credit to GDP, interest rate gap, liquid liabilities to GDP, stock market capitalization to GDP, financial market sophistication, and financial regulation and supervision.
- Greater access to credit for consumers and businesses.
- Commitments at the WTO.



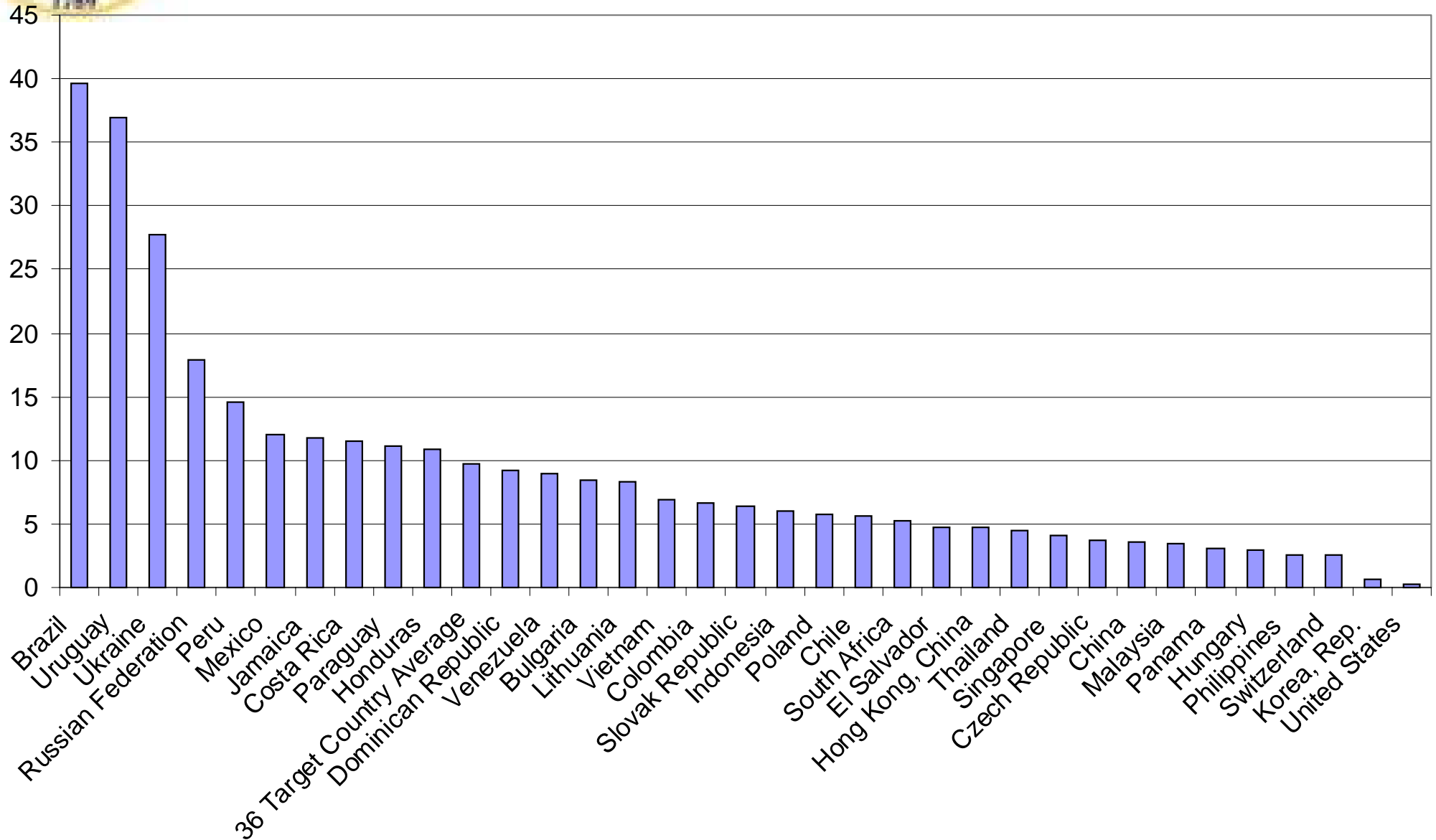
Private Credit to GDP



Private Credit to GDP measures the activity of financial intermediaries. This measures the activity of financial intermediaries in one of its main functions: channeling savings to investors.



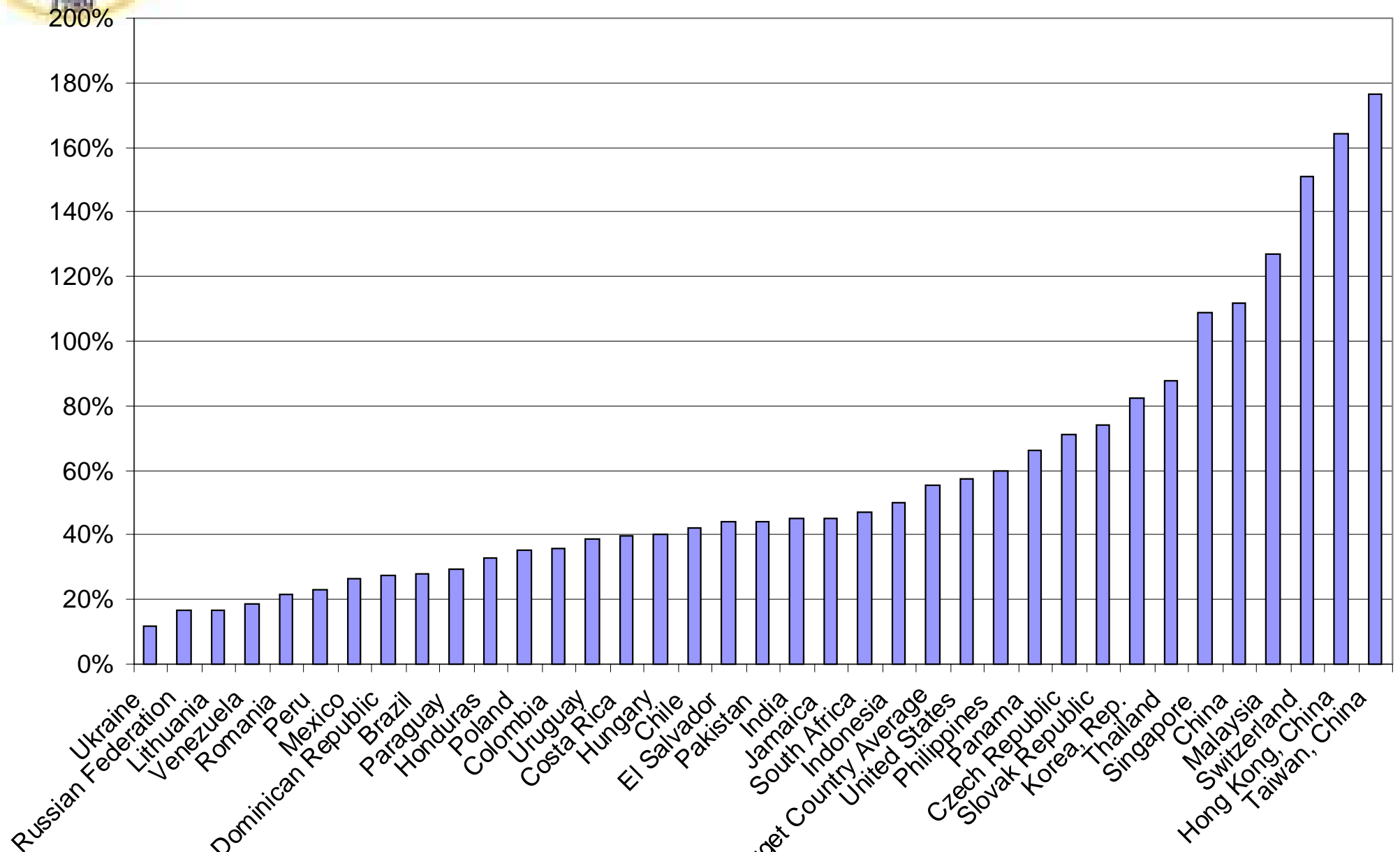
Interest Rate Gap



Interest Rate Gap is the gap between lending and deposit rates. It measures the efficiency of bank's ability to channel funds from savers to investors.



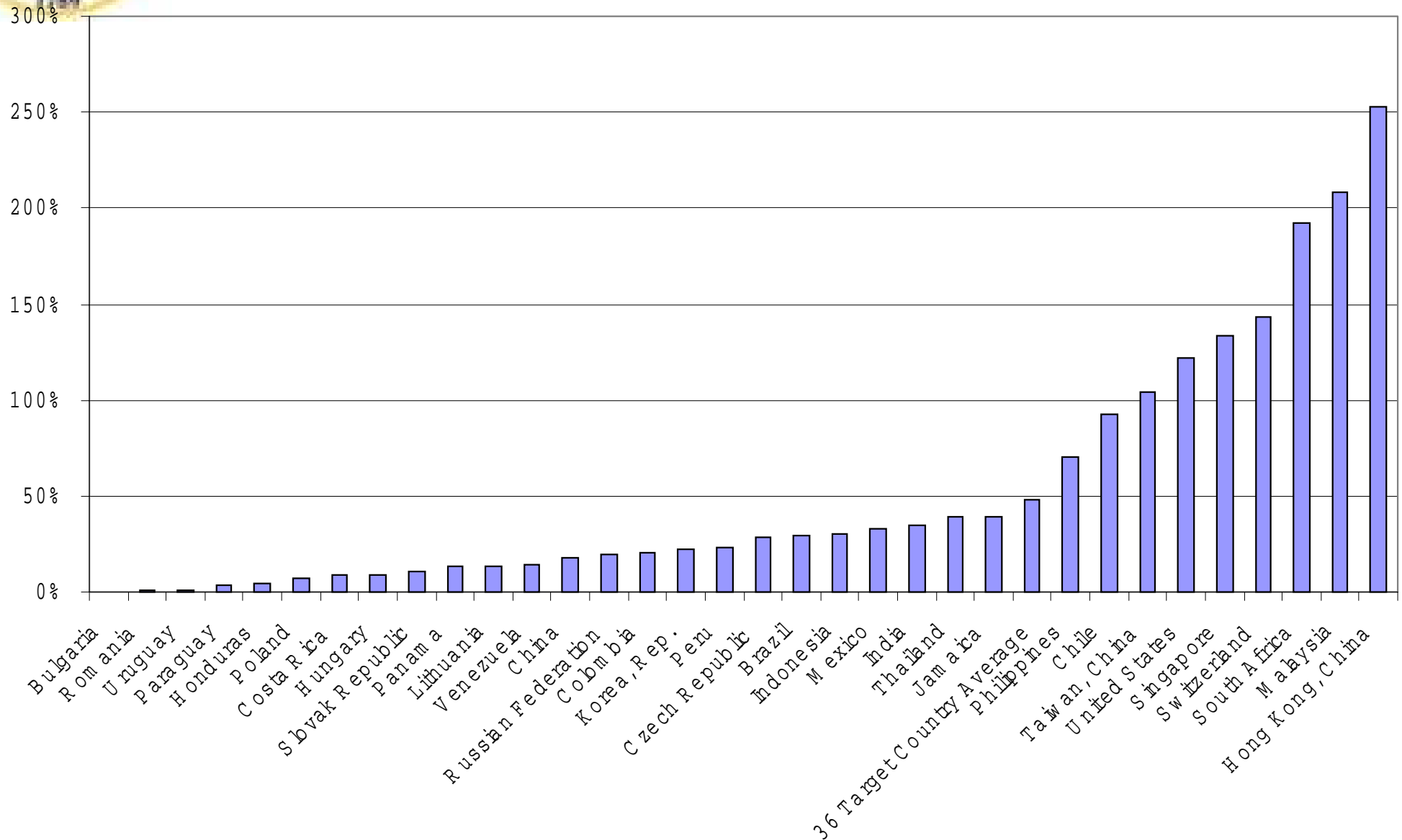
Liquid Liabilities to GDP



Liquid Liabilities to GDP examines (M2) to GDP, illustrating the depth of a country's financial payments system.



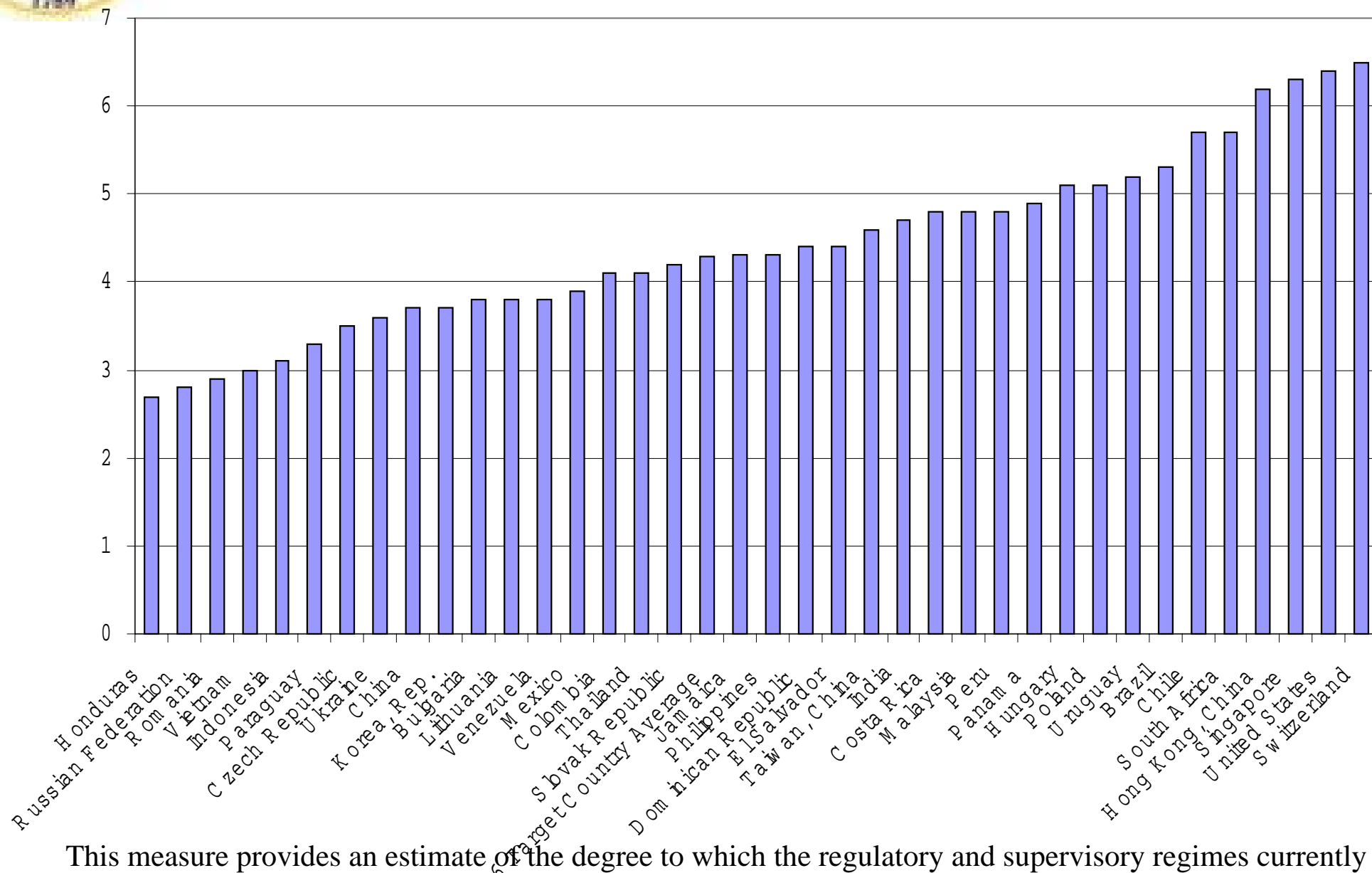
Stock Market Capitalization to GDP



Stock Market Capitalization to GDP measures the depth of a country's private capital relative to the economy and reflects the potential for trading risk and boosting liquidity within the country.



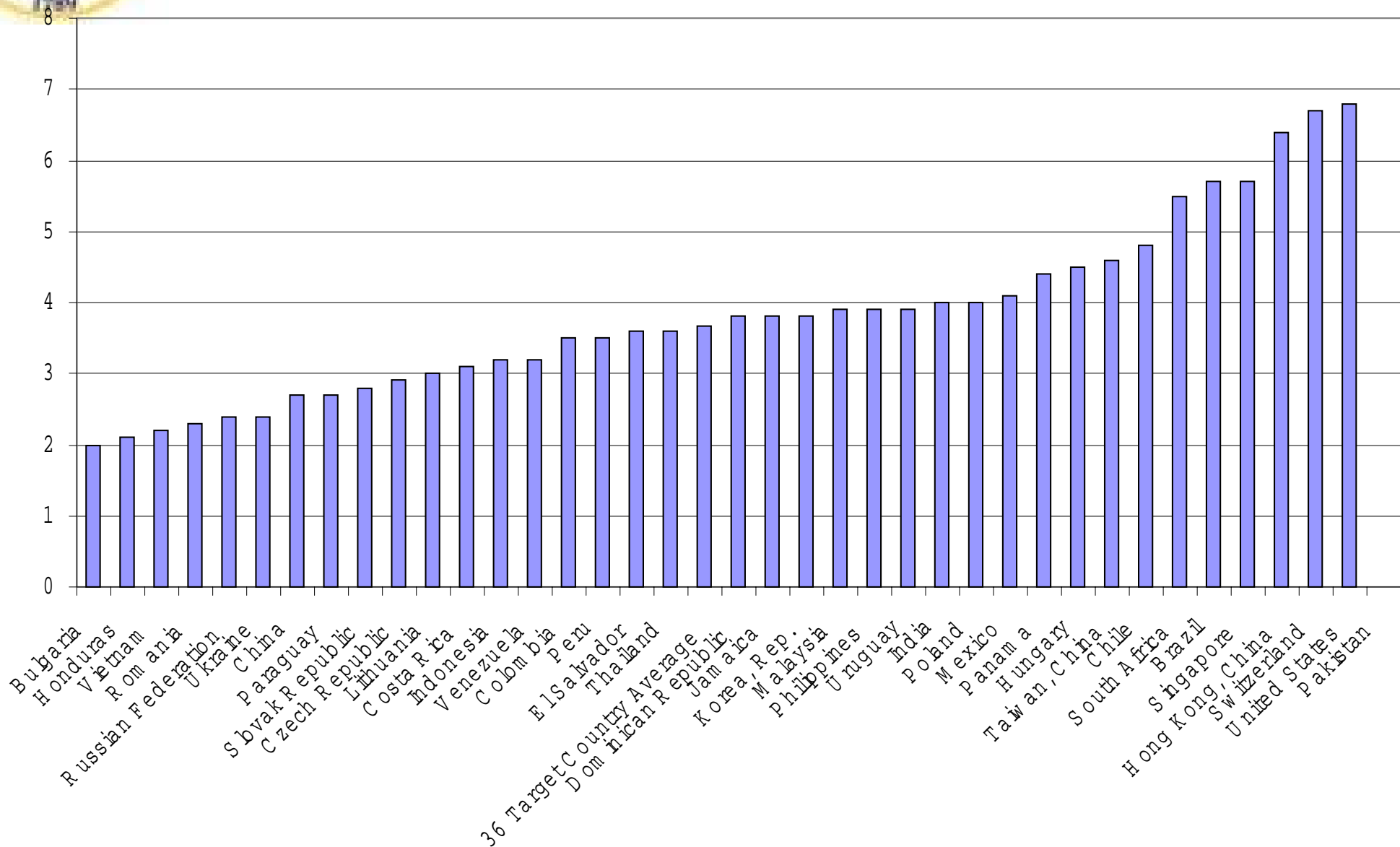
Financial Market Regulation and Supervision (1 to 7)



This measure provides an estimate of the degree to which the regulatory and supervisory regimes currently in place can support financial stability. A score of 1 indicates that financial regulations and supervision are inadequate for financial stability, while a score of 7 indicates that they are among the world's most stringent.



Financial Market Sophistication (1 to 7)



Financial Market Sophistication estimates the a country's level compared to the most highly developed financial markets (From World Economic Forum Survey).